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The International Comparative Legal Guide to:

Private Equity 2019

5th Edition

A practical cross-border insight into private equity

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PREFACE

We are privileged to have been invited to preface the 2019 edition of *The International Comparative Legal Guide to: Private Equity*, one of the most comprehensive comparative guides to the practice of private equity available today. The Guide is in its fifth edition, which is itself a testament to its value to practitioners and clients alike. Dechert LLP is delighted to serve as the Guide's Editor.

With developments in private equity law, it is critical to maintain an accurate and up-to-date guide regarding relevant practices and legislation in a variety of jurisdictions. The 2019 edition of this Guide accomplishes that objective by providing global businesses leaders, in-house counsel, and international legal practitioners with ready access to important information regarding the legislative frameworks for private equity in 31 different jurisdictions. This edition also includes five general chapters, which discuss pertinent issues affecting private equity transactions and legislation.

The fifth edition of the Guide serves as a valuable, authoritative source of reference material for lawyers in industry and private practice seeking information regarding the procedural laws and practice of private equity, provided by experienced practitioners from around the world.

Christopher Field & Dr. Markus P. Bolsinger

Dechert LLP

2019 and Beyond: Private Equity Outlook for 2020

Ross Allardice

Dechert LLP

Dr. Markus P. Bolsinger

I. Introduction

In 2018, the global private equity (PE) industry continued to make deals, pursue exits and raise capital. Limited partners remain committed to investment in funds and portfolio companies alike and continue to provide fresh capital as part of new fundraisings.

Heavy competition across all asset classes has seen seller valuation expectations pushing deal multiples to historic highs. For general partners, putting record amounts of capital to work has led to exploration of non-traditional asset classes and a requirement to be creative across capital structures whilst identifying targets and planning for the worst against the backdrop of Brexit and the tariff wars between the US and China.

Funds are therefore continuing to further diversify into credit, real estate, infrastructure and growth investments. Larger funds are creating more strategic funds with lower return expectations and longer hold periods, as well as smaller funds addressing smaller cap transactions. PE dry powder has been on the rise since 2012 and hit a record high of $2 trillion at year end 2018.

More liquidity in the market coupled with a limited number of attractive assets means competition for those assets is fierce. This impacts the acquisition process on any auction or bilateral deal. In order to successfully acquire attractive assets, PE buyers must transact within a tight timeframe and on seller-friendly terms (with limited seller recourse and more aggressive pricing structures).

Consequently, PE funds have to be creative to ensure capital is deployed timely and effectively.

II. Trends in the PE Market

Buy and Build Strategy

Larger funds are beating strategic buyers at their own game by executing large-scale strategic mergers that create value out of synergies and combined operational strength and by implementing more ambitious buy-and-build strategies. Such structures allow general partners to justify the initial acquisition of a relatively expensive platform which can then act as a foundation for further strategic add-on acquisitions that can be acquired for lower multiples as part of a longer-term focused strategy. Further strategic acquisitions have the effect of reducing the overall acquisition cost of such platforms. However, optimising the implementation of a buy-and-build strategy requires GPs to adapt and diversify traditional investment approaches, as well as familiarising investors with longer-term hold strategies.

Portfolio equity minority stakes

Consistent with the need for PE sponsors to seek alternative opportunities for capital deployment and value, there has been a significant increase in the volume of minority investments and partnership structures by PE sponsors over the course of 2018 and this is expected to continue. Throughout this period, we have continued to see the invocation of alternative capital structures (from pure common equity investments with certain control/veto rights as well as preferred equity or debt-like structures with limited governance rights but with the ability to participate in equity returns (i.e. through warrants)).

A seller in a minority deal may be looking for more than a financial return and may be more interested in investment by firms that also have a deep knowledge and network to expand its business internationally and be willing to cede certain control and veto rights in order to obtain the investment (particularly, where there is the opportunity to potentially obtain step-up economic and control rights over a longer-term horizon).

In addition, the hunt for valuable assets has led to a renewed interest in founder-led and family businesses which often lend themselves to partnership capital structures. This trend has been particularly visible in central and eastern Europe and the Middle East where we have continued to see a growth in transactions of this type. The desire of founders to retain an ongoing interest in trophy assets over the long-term has also complemented the growth of funds focused on long-term holds and the continued increase in activity of historically passive investors, including pension funds and family offices.

The growth of strategic partnership investments is another example of PE using the capital structure and opportunities to take advantage of trophy assets and set themselves apart through expertise rather than just buying power.

GP equity minority stakes and LP transfers

We have seen in the past few years, general partners and limited partners taking direct minority stakes in portfolio companies with increased frequency. In addition, traditional PE firms like Bridgepoint are selling minority stakes in themselves. Firms like Dyal Capital and Blackstone are raising billions of capital for "fund

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of firms" vehicles dedicated to buying portfolios of GP minority stakes. This market for GP minority stakes is a natural extension of a mature PE market. Selling GP stakes this way means firms can deploy further capital to fund growth initiatives. For the investor, striking a close relationship with a GP can result in better terms for the firm's primary fund as well as direct co-investment opportunities.

In addition to the growth in transfers of GP stakes, we have witnessed an increased frequency of transfers of LP interests by PE sponsors. These transaction structures are being used creatively in order to allow sponsors to retain trophy and high-growth assets (avoiding potential negative investor sentiment regarding so-called "pass the parcel" transactions) and to hold portfolio assets for longer periods and in order to ensure strategic alignment between sponsors and investors.

Co-investment Opportunities

In recent years, PE funds have had to change tack in order to meet the demands of investors and give themselves a competitive edge. In the industry's early years, it used to be that funds could rely on financial engineering to achieve returns. One of the most striking developments in recent times has been the collaboration of sponsors with strategic investors. This has come in two forms:

- giving LPs direct access to deals as co-investors thereby increasing a PE fund's firepower and ability to complete larger deals; and
- bringing in corporate co-investors on buyouts, again increasing financial firepower and bringing valuable industry knowledge to the portfolio company and a potential suitor to exit to in the future.

In addition, LPs have come to seek greater levels of co-investment as a means to improve investment performance by reducing management fees.

Direct lending and alternative capital growth

2018 has been notable for the continued growth of transactions funded through leverage provided by debt-funds rather than from traditional sources of loan finance. The ability of debt funds to offer more creative structures and leverage multiples in excess of those provided by banks, coupled with the increasing amounts of investor capital being deployed within debt funds means that this trend is expected to continue. Given potential economic headwinds, the rise of the direct lenders is expected to enhance momentum in deal flow even if traditional financing sources become unavailable, or where the leverage available from such sources decreases.

However, the ability to obtain enhanced leverage, along with the ability of sponsors to cherry-pick advantageous debt terms in a competitive market could, in the context of significant economic upheaval, feasibly lead to an increase in defaults and associated work-out scenarios, particularly as regards assets which have significant exposure to macro-economic trends.

Take private transactions

In the last two years there has been a considerable increase in interest in take-private transactions across Europe. We expect this to continue. More than half of the successful take-private transactions in the UK in the past two years have been sold to PE sponsors.

In the first quarter of 2019, key stock indices lost gains made throughout 2018 which will provide PE funds with an opportunity and focus on certain undervalued assets (especially publicly listed companies experiencing stock price decline).

Whilst the requirement for the ability to control their investments will continue to represent a roadblock for traditional PE sponsors, the amount of capital available for deployment, together with the rise of non-traditional equity investors, provide positive indications of the potential for the return of strategic minority investments into public companies (so-called "PIPE" investments).

Subscription lines

Whilst subscription lines offer general partners the opportunity to act quickly in an auction (by avoiding the need to wait for investor commitments through a capital call process before a transaction can be completed), the use of subscription lines (and the increase of the use of subscription lines for longer-term bridge financing purposes) continues to be a contentious issue from an investor perspective. This is where loans to general partners are secured against investor commitments and have the potential of improving returns through financial engineering rather than the quality of investments by the general partner. The internal rate of return on which PE fund managers are commonly judged is sensitive to when PE investors' cash is put to work. Subscription lines allow fund managers to draw down from their investors at a later date improving the fund's IRR in the process. Accordingly, it is expected that investor pressure for more rigorous control on the use of subscription lines in fund documents will increase and, with funds focused on long-term holding periods, for the use of multiple-of-money investor return metrics (alongside or *in lieu* of IRR metrics) to continue to grow.

Growth Equity

The rise of growth equity in the past five years is striking. Since 2014, some $367 billion has been raised globally for growth equity and for many larger PE funds this pool of capital offers a way to focus on fast growing companies and achieve a return without the need for high leverage multiples. Growth equity occupies the space between buyout which focuses on companies with years of proven cash flow and profitability and venture capital which invests in start-ups that are generally yet to generate EBITDA and are still in development mode. Growth equity is closer to traditional leveraged buyout funds and this is why we are starting to see larger established funds set aside pools of capital for growth equity deals.

III. Outlook

While fundraising trended down in 2018 in line with a weaker exit market and lower distributions to investors, the amount of dry powder available is at a historic high and must be put to work. As a consequence, this dynamic means that deal-making activity is likely to remain robust and competitive through to the end of 2019 and into 2020, as managers continue to try and navigate a highly competitive and well capitalised PE market by using some of the methods outlined above.

We should therefore expect the trend of increased asset prices and seller-friendly terms to continue along with further diversification by general partners looking for new avenues (in line with the themes above) in which to make returns from their increasing amounts of committed capital, even in the face of economic headwinds. That said, global events may also provide significant opportunities for investors to acquire distressed assets at advantageous valuations as well as rewarding those sponsors who are implementing creative and innovative investment strategies.

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Mark Evans, a corporate and securities associate at Dechert LLP, also contributed to this chapter.

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Ross Allardice's focus solely on financial sponsor matters means he sees a large number of transactions across the European private equity, portfolio and restructuring space. He is heavily involved with every phase of a transaction and has an excellent understanding of current market terms in the financial sponsor market. He represents parties across multiple industry sectors.

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Dr. Markus P. Bolsinger, co-head of Dechert's PE practice, structures and negotiates complex transactions – domestic and transatlantic M&A, leveraged buyouts, recapitalisations and going-private transactions – and advises on general corporate and corporate governance matters. Dr. Bolsinger's experience extends across industries, including healthcare, industrial, packaging, agribusiness, consumer, food and beverage, and restaurant sectors. His clients have included leading PE firms, such as First Atlantic Capital, ICV Partners, J.H. Whitney & Co., Morgan Stanley Capital Partners and New Mountain Capital. In addition to his core M&A and PE experience, Dr. Bolsinger has extensive expertise in transactional risk insurance, and frequently speaks and writes on the topic in major media outlets.

He has been listed as a recommended lawyer by the U.S., EMEA and Germany editions of *The Legal 500*, a legal directory based on the opinions of clients and peers. Recognised for M&A and PE buyouts in 2018, Dr. Bolsinger has been cited as "a trusted adviser" who "takes the time to understand a client's business and motivations before undertaking any way". Since 2010, every year Dr. Bolsinger has been recognised and received a *pro bono* service award.

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Dechert is a global law firm focused on sectors with the greatest complexities and highest regulatory demands. We deliver practical commercial insight and judgment to our clients' most important matters. Nothing stands in the way of giving clients the best of the firm's entrepreneurial energy and seamless collaboration in a way that is distinctively Dechert.

Dechert has been an active advisor to the private equity industry for more than 30 years – long before it was called "private equity". As a result of our longstanding roots and diverse client base, we have a deep understanding of the latest market terms and trends and provide creative solutions to the most complex issues in evaluating, structuring and negotiating PE transactions. Ranked among the top law firms for PE by prominent league tables and legal directories, Dechert's global team has been recognised for its commercial judgment and client focus.

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Private Equity Transactions in the UK: the Essential Differences from the U.S. Market

Dentons

Nicholas Plant

Introduction

A U.S. private equity fund seeking to acquire a business in the UK will soon notice a number of differences from the U.S. market. It is important to be aware of these differences if you are competing against UK private equity houses.

The key features are that in the UK we have a far more seller-friendly approach and management incentives are structured differently (however, they achieve much the same economic result).

Seller-friendly

Below are 11 ways in which the UK approach (and English law) is more seller-friendly.

Deal Certainty

The common theme among the first three distinctions is deal certainty. A typical UK agreement assumes that, even where there is a gap between signing and closing, deal certainty is required from signing.

1. ***Conditions***: Typically, UK agreements contain only those closing conditions required by law or regulation, i.e. "mandatory" conditions (e.g. anti-trust clearances or other regulatory approvals). These are generally specified together with detailed provisions on timings for filings and consequences based upon the response from the relevant regulatory body. By contrast, U.S. deals are more likely to have greater conditionality and sometimes to provide for a substantial period of time before closing, known in the U.S. as the "marketing period", for the buyer to have a fair shot at securing acquisition financing.
2. ***Material Adverse Change***: It is unusual for UK deals to be subject to a MAC condition. Even if a MAC condition is included, it is likely to be relevant only if an "armageddon" event occurs in respect of the target business itself which is not the result of macro-economic factors. It is also frequently constructed so that it is only triggered by a change that has a specified financial consequence on the target group. The aim of this approach is to bring certainty by clearly defining the trigger for the MAC (rather than leaving it to a court or arbitrator to decide whether the impact of a future event is "material"). By contrast, MAC clauses are far more common in the U.S., although they are also interpreted very narrowly. Conceptually, that makes sense because in the U.S. risk is not considered to pass to the buyer until closing (see *Transfer of Risk* section below).
3. ***Financing***: UK deals are usually done on a "certain funds" basis with no financing condition or financing out. But some private equity and strategic deals in the U.S. contain financing conditions. In the UK, we would argue that makes the acquisition agreement little more than a call option.

   If in the U.S. there is no financing condition, as is the case in virtually all U.S. large cap private equity deals, there will typically be a reverse termination fee which requires the buyer to pay a fixed amount if the financing is not available and the other closing conditions are met. This reverse termination fee is usually the seller's exclusive monetary remedy against the buyer. Although reverse termination fees are seen in the UK, they are relatively rare, certainly by comparison with U.S. practice.

Transfer of Risk

The common theme among the next three distinctions is the timing of when the risk (and benefit) of ownership transfers.

4. ***Price certainty***: It has been common for a number of years in English law acquisition agreements, particularly in auctions, for the acquisition price to be structured on a "locked box" basis. That is, the price payable for the target company is agreed upon in advance of signing based on a balance sheet drawn up to an agreed date (the "locked box date"). The buyer then bears the risk and reward of the target's performance from the locked box date through signing to closing. In return, the seller undertakes that there will be no "leakage" of value from the target company to the sellers in that period in the form of dividends or otherwise, i.e. the box is "locked" from the locked box date. This is entirely in keeping with the philosophy that risk passes to the buyer from signing. The advantages for the seller in using a "locked box" include the ease with which bids can be compared and price certainty (as there is no post-closing adjustment).

   Although the use of the locked box mechanism is increasing in the U.S., it is still common to have a purchase price adjustment based on the working capital or net worth of the company as of the closing date (which is typically estimated at closing and trued up post-closing), and the seller is free to make ordinary course distributions out of the company during the interim period. Unlike the locked box mechanism, and depending on the precise formula used in any particular adjustment, the seller retains the commercial risk and reward until closing. Furthermore, the seller has less control over the final amount of the purchase price, and the price is likely to be subject to a post-closing adjustment and potential dispute based on the closing accounts.

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5. ***Control between signing and closing***: The covenants to which the target business and seller are subject in the period between signing and closing are likely to be significantly more prescriptive and extensive in the UK than in the U.S.
6. ***Repetition or "bring down" of warranties and representations***: In the UK, it is unusual for warranties to be repeated (or "brought down") at closing, although, as a compromise, sellers may agree that a small number of fundamental warranties, such as those regarding title, insolvency and material litigation, are repeated at closing. In the U.S., the practice is generally to require representations and warranties to be repeated on closing or, at the very least, include a closing condition that gives the buyer the ability to terminate the transaction for a material breach of warranty and representation prior to closing.

Seller's Liability

The position on seller's liability when comparing the UK and U.S. is more balanced. On the one hand, a UK private equity seller will not give any warranties (other than title and capacity) and other warrantors are unlikely to repeat them on closing. Also, disclosure will be more comprehensive. On the other hand, the scope of warranties and caps and time limits on liability are likely to be broader, higher and longer in the UK than the U.S.

7. ***Limits on Liability***: Private equity sellers in the UK never give business warranties in an acquisition agreement (except for title and capacity). Instead, a buyer relies on warranties received from the management team. That, combined with a management team rolling over 50% or more of its post-tax sale proceeds, gives the buyer some comfort in what it is acquiring. If a buyer requires a higher level of recovery against the purchase price in the event of a breach of warranty, then it can also acquire warranty and indemnity insurance. Warranty and indemnity insurance is now very common in the UK private equity market. The premium costs around 1% of the amount of insurance cover provided and the deductible (also known as the "attachment point", "retention" or "excess") is usually set at 0.5% of the enterprise value of the target company – but is sometimes as low as £1. Most unknown liabilities will be covered by the insurance. Common exceptions are: transfer pricing; secondary tax liabilities; any pension funding shortfall; holiday pay; environmental warranties; and product liability. Typically, the buyer will still seek these warranties and rely on the fact that, under English law, the limitations on liability (including the warrantors' cap on liability) will cease to apply in the event of fraud.

   In the U.S., the construct is different. A selling private equity fund is unlikely to give business warranties and any management liability of the kind seen in the UK is extremely rare (perhaps reflecting the reality that a lawsuit against one's new management team is an unattractive proposition). However, both the selling private equity fund and management team may fund, proportionate to their shareholdings, an escrow in an amount equal to 5–10% of the equity value. The escrow is typically paid over to the seller once the representations and warranties expire, subject to reserved amounts for any pending claims. The corollary of this is that in the U.S. the seller's representations and warranties can survive for as little as the first anniversary of the closing or, alternatively, the completion of the first audit cycle under the buyer's ownership. By contrast, in the UK, time limits tend to be longer – typically two years for non-tax warranties and seven years for tax warranties. However, the warranty and indemnity insurance is invariably structured so that the warrantors themselves cease to be liable for the deductible after the first anniversary of closing.

   Also, in the UK, express contractual indemnification is far less common than in the U.S. except in relation to tax or other specifically identified risks (e.g. environmental exposure). The buyer's remedy for breach of a warranty in a UK acquisition agreement will instead usually be a contractual claim for damages, with a duty to mitigate losses and a requirement for any damage to be reasonably foreseeable. Some U.S. deals actually end up with a similar result, notwithstanding the express contractual indemnification due to waivers by buyers of consequential damages and a contractually imposed duty to mitigate.
8. ***Disclosure***: The style and substance of the disclosure process differs between UK and U.S. documents. Under a UK acquisition agreement, the seller's disclosures are typically contained in a separate disclosure letter, rather than the schedules to the sale agreement itself, which is often the case in the U.S. A UK disclosure letter will contain a mix of general and specific disclosures against the warranties. Even the specific disclosures are normally deemed to qualify all warranties and not just the specific warranties to which they relate. More significantly, in auctions it would be usual for the entire contents of the data room and of any vendor due diligence reports to be deemed to be generally disclosed against the warranties. In the U.S., the buyer will usually allow specific disclosures against specific warranties, and any other warranties as to which it is readily apparent that such disclosures might relate. General disclosures, or imputations to buyers of the entire contents of the data room, are far less common in the U.S. and not typically accepted by U.S. buyers.
9. ***Specific Performance and Liquidated Damages***: While the test for granting specific performance is the same between the U.S. and the UK (i.e. monetary damages would not be an adequate remedy), an order for specific performance is generally easier to obtain in the U.S. than the UK. Liquidated damages are also easier to obtain in the U.S., because in the UK the onus is on the enforcer to prove that the amount claimed is a reasonable estimate of its loss, i.e. UK courts do not award penalties.
10. ***Buying from an Administrator***: In the UK, our equivalent of buying a business out of Chapter 11 is acquiring it from an "Administrator". Buyers of businesses from an Administrator will, typically, receive no warranties or representations on the target business from the sellers, and have no post-closing recourse against the sellers. At best, they will receive a warranty from the Administrator confirming the validity of his appointment. It is possible for the buyer to have an escrow arrangement or deferred consideration, but if there are competing bids the Administrator will favour the bid that provides the maximum cash payment on closing. The solution is for the buyer to price in the risks.

Finally

11. ***Process***: Vendor legal due diligence (where key legal due diligence materials are prepared in advance of the sale process and designed to be relied on by the successful bidder) is common in the UK. It may be particularly helpful if the target company has "issues" which require explanation and/or if the target business is international and therefore expensive to diligence and/or if the timetable is aggressive.

    By contrast, in the U.S. it is rarely used, largely because of litigation risk and scepticism on the part of U.S. buyers as to the level of comfort offered.

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Conclusion

These differences demonstrate why U.S. sellers might prefer that their international deals are done under UK law. However, in making tactical decisions about the choice of law, sellers should be mindful of the geographic location of the likely pool of buyers. It would make no sense to have English law if both the pool of bidders and target itself are based outside of the UK.

Management Incentives

In the UK we structure management incentives a little differently from the U.S., but with much the same economic result.

In the UK, all share incentives are awarded to the management team on closing, but all are subject to forfeiture if the manager leaves before the exit. The reason is entirely tax-driven, i.e. if shares are awarded at less than their market value at the time of award, then the recipient will suffer income tax on the difference between the price he pays (if lower) and the market value. The employer will also suffer a tax bill on the difference (employer national insurance which is currently charged at 13.8% on the difference). Because it is assumed the market value of the shares will increase during the lifespan of the investment, it therefore makes sense to award all the incentives at the outset of the investment period. That is why the issue of shares during the investment period pursuant to staggered vesting under an option plan makes no sense in the UK.

If a manager leaves before the exit, then all his shares will be forfeitable. The legal construct is the leaver must offer the shares for sale (so the eligible shareholders will have a call option over the leaver's shares – in no circumstances will the leaver have a put option). The question is at what price. A bad leaver will be required to offer his shares for sale at the lower of market value and the subscription price (because if the subscription price is set as the floor and the shares subsequently become worthless, it would have the perverse result of incentivising the management team to voluntarily resign). The price paid to a good leaver will be market value. A third category has developed in the UK market – the intermediate leaver, who is essentially someone dismissed without cause on full notice. He will receive the lower of market value and the subscription price for a portion of his shares and market value for the balance. The portion that must be offered for market value will increase in line with how long the relevant manager has been in the business. This is what we call "value vesting". Four years is a typical period for the manager's entire holding to "value vest", i.e. be forfeitable entirely for market value. This last category achieves the same economic outcome as the "actual vesting" that one sees in the U.S.

Two countries divided by a common language – indeed!

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Nicholas receives exceptional praise from market sources. He is named as a "leading individual" by *Chambers & Partners*. It quotes clients who describe him as "technical" and "very client-focused" – *Chambers UK 2016* (Private Equity). It also says Nicholas "is a well-known private equity lawyer whose clients include leading players" – *Chambers UK 2017* (Private Equity).

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Management Incentive Plans – The Power of Incentives

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"People Respond to Incentives"

Much has been written about the power of incentives, the risk of distortion of behaviour and the unalterable fact that all incentive systems tend to promote "gamification" or, in other words, behaviour that is designed to maximise the incentive reward, regardless of whether or not that actually meets the objectives of the business or investor providing the incentive.

Whilst the psychology of incentives is beyond the scope of this article, the one statement that all commentators agree on is "*people respond to incentives*", and the incentives provided by private equity houses to their management teams (invariably in the form of equity incentive plans in one guise or another) are amongst some of the most powerful incentive structures in the corporate world.

With desirable assets in hot demand and with many private equity houses competing to win assets through auction processes, competition is no longer simply a matter of price: bidders must also battle for the hearts and minds of the senior management team and often win a competition of generosity when it comes to incentives and benefits. Against this backdrop, there are an increasing number of sophisticated management teams who have experienced private equity ownership before and, assisting them, a growing phalanx of dedicated advisory teams who solely represent management in agreeing incentive arrangements with private equity houses. As a direct result of these dynamics, management incentive packages have become increasingly complex and diverse. This article seeks to explore some of the key areas for consideration when establishing and administering a management incentive plan ("**MIP**").

Perhaps predictably given the variety in this area, MIPs are known under a number of different monikers (many use the term "MEP" (management equity plan) instead, for example). For the sake of brevity, this article will use the term MIP throughout.

Fundamentals of a MIP

Ensuring alignment

The essence of a MIP is to align the interests of the target company management with those of the private equity house itself. As such, the key elements of alignment include:

- **What is measured (cash on cash)**: One of the distinctive features of private equity investment that is noticeably different from evergreen hedge funds and other open-ended investment structures is the concept of a cash-on-cash return and reward structure at all levels. When evaluating a fund's performance, whether in terms of IRR or money multiples delivered, invariably for private equity the measure is tested on cash invested compared to cash returned and the time period in between. At the heart of most MIPs is the principle that managers will not see their benefits crystallise until they achieve a suitable cash return for the investor.
- **When value starts to flow (the hurdle)**: The senior managers at a private equity house will generally only benefit from performance fees or carried interest payments where the fund is delivering to their own investors a level of return which exceeds the fund's pre-set hurdle. As such, it is common to import that same hurdle (or, if the competitive landscape permits, a higher hurdle) directly into the portfolio company incentive plan so that managers of the portfolio companies themselves start to participate in an increase in the capital value of those portfolio companies only when a cash return to the fund is being delivered which satisfies the "upstream" hurdle requirement; or, more simply, the MIP is designed to ensure that the management team is not being rewarded unless it is contributing to fund performance at a level that should reward the private equity managers themselves.

The premise, therefore, is a simple one: the management team makes money when the house makes money, the better the house does, the better the management does and, in all cases, what is tested is cash invested *versus* cash realised and the period of time in between. As with all simple premises, however, complexity, detail and nuance inevitably apply and can lead to some material issues of non-alignment, and can equally lead to materially different value outcomes.

Capital structure

Understandably, MIPs require an overall understanding of how the capital structure of a leveraged buyout is composed. A significant proportion of the acquisition cost of the relevant company will typically be funded through third-party debt finance with the balance being funded by "equity investment".

However, the equity investment itself is rarely as straightforward as comprising a simple issue of ordinary shares. As far as the private equity house is concerned, the bulk of its investment will be made in the form of a preferred instrument (either a loan note or a preference share) which will carry a preferred return (i.e., an amount equal to the hurdle mentioned above). In addition, the preferred instrument will invariably rank ahead of all ordinary equity, so, in the event that an investment is less successful, on an exit once all debt has been discharged, the first slice of equity value will go to pay that preference instrument and its hurdle return before any value flows to

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the ordinary equity. In other words, as far as the true "ordinary" equity is concerned, the preferred instrument represents another element of leverage that must be discharged in priority to receiving any value for those ordinary shares held. As a result, the actual cash price of the ordinary equity will typically be only a small fraction of the total "equity investment" being made. In industry parlance, the loan notes, preference shares and ordinary shares held by the private equity house comprise the "institutional strip".

"Sweet equity" is the term often used to describe those shares offered to management which give the holder a material percentage stake in the ordinary equity for a relatively low cost or returns based on a ratchet or similar mechanism. Before any value accrues to that ordinary equity, they will need to deliver (invariably by way of an exit or some combination of recapitalisation and exit) a level of return that will discharge debt finance and repay to the private equity investor the entire amount of its preferred instrument plus the preferred return. Also, the business will have to generate sufficient free cash flow to service cash interest payable on its third-party debt throughout the life of the investment. The economic result is that whilst, for a typical leverage transaction, there may be "equity investment" equal to 30% or 40% of the total price of the asset being acquired, for a management holder who only has an interest in sweet equity, it is as though they are sat behind a structure that is almost entirely comprised of leverage. Leverage ratios themselves remain variable by sector and sponsor. Consequently, and as with all leverage structures, relatively small levels of under-performance can leave that ordinary equity worthless and "under water" with value being exclusively used to discharge third-party debt and to repay the investor fund the majority of their equity investment and hurdle return, whereas strong levels of performance will very rapidly deliver significant value into that ordinary equity stake, thereby creating a powerful incentive to deliver the higher level of capital gain sought by private equity investors.

The hurdle

A key question as to the level of value that will ultimately flow to the ordinary shares is what level of hurdle return has to be met on the private equity investor's preference instrument. The typical hurdle rate has moved materially as economic conditions and expected returns have moved, with the overall direction of movement tending downwards from a high point before the financial crisis of typically 12–16% to a current more typical range of between 8–12% (in all cases calculated on a basis that will roll up and compound, in some cases daily and in some cases quarterly or annually).

Increasingly, well-advised management teams (and perhaps particularly those teams where the management equity will be tightly held) place their negotiating focus on the hurdle rate rather than simply concentrating purely on the amount of ordinary equity made available to them. The thinking here is simple: it is better to participate in exit proceeds (albeit to a lesser extent) than not to participate at all due to a particularly onerous hurdle rate.

MIP Resets

Due to the hurdle rate, it is not unusual to find that either no or very little value accrues to the ordinary equity on an exit. Where this becomes apparent during the life of an investment, it inevitably raises the question of whether there should be a "reset" of the incentive arrangements. Whilst there are always concerns over payment for underperformance, it is typically the case that new management is required to lead a turnaround. The ability to attract and retain such a turnaround team will again require consideration to be given to the incentives on offer; only now instead of starting with a blank canvas, the incentive needs to be overlaid on an existing capital structure where the ordinary equity is underwater.

Where this issue arises, it is best addressed as early as possible and ideally far ahead of any exit; the private equity seller will want a motivated management team that is focused on the turnaround, and a team that is prepared to provide exit warranties, and any incoming investor will, if nothing else, want comfort that management have been incentivised to conduct a thorough disclosure exercise.

Exactly what form the incentive reset takes will vary depending on the original capital structure and the new value reality, and may include creating a new class of MIP shares that participate alongside the preference instruments held by the fund, providing options to the management over the investors institutional strip, bonuses payable by the company, bonuses payable by an investor entity and cash payments being made in return for the management giving warranties (all of which may receive very different tax treatments). A simple "forgiveness" of debt or release of the preferred instrument invariably will be tax inefficient and lead to significant costs both to the business and potentially the existing and new shareholders.

What is significant here is the timing of the discussion. Left too late, this issue can impose substantial additional tax costs, can derail the sale process and can leave management feeling disenfranchised and unmotivated before the turnaround has even begun.

Sweet equity

Typically, sweet equity is offered to management at the same low price-per-share as the price paid by the private equity fund but with no obligation on management to invest and pay for a proportionate amount of the preferred instrument. Sweet equity will be subordinate to all third-party debt and the preferred instruments subscribed for by the private equity funds. The total amount of sweet equity set aside to operate as an incentive for management will obviously be a key determinant of the generosity of any MIP. Equally, the cost of the third-party debt and the level of return required to be delivered in order to meet the private equity house's preferred instrument hurdle will affect how easy or difficult it is to create value in that ordinary equity.

A current market "standard" allocation has been to set aside 10–15% of the ordinary equity for granting of management equity incentive awards, although for some transactions much lower percentages are allocated to management whilst in other transactions up to 25% of the ordinary equity may have been ring-fenced for management participation. The fact that a certain "pot" has been made available is of course distinct from individual allocations, and it is common not to issue the entire amount of the pot on an initial transaction but to reserve an element of that pot for the purposes of attracting new talent into the management team in the future, and to proffer a "carrot" to the existing team of future rewards.

More often than not, managers realising significant value in one exit will be expected and/or required to reinvest a significant proportion of their exit proceeds in the institutional strip – possibly between 20–50% of their net proceeds. This can also apply to new managers of a portfolio company who have a track record in previous portfolio company roles and where people are receiving exit bonuses, often a higher proportion can be required.

Pricing and valuation

If the sizes of the pot available and the hurdle return it sits behind

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are key value questions, then equally so is the question of how much it will cost management to acquire a given percentage of the sweet equity. In this regard, UK practice differs from that seen in the US and Europe quite materially.

At the heart of that difference between UK and other practices lies the question of valuation and taxation.

Receiving an offer of shares tends to be treated much like any other employment-related benefit when it comes to taxation. If an individual is receiving the entitlement by reference to their employment status (or is deemed by tax law to be by reference to their employment status, which is invariably the case), and if there is an element of "benefit" to the individual as a result, then the element of "benefit" will typically be taxed under the relevant employment tax regime in much the same way as a benefit in kind charge can arise in respect of the provision of company cars, entertainment allowances, healthcare benefits and the like.

Most MIP structures seek to avoid a benefit in kind charge arising through the seemingly simple construct of having individuals pay market value for the shares that they are being offered, so that no element of "benefit" arises. In determining what market value might comprise, obtaining an independent third-party valuation for the equity interest being offered is typical; and the fact that the offer of securities when the MIP is established is almost invariably combined with an arm's-length third-party acquisition of the underlying target company and the subscription by the private equity investor of similar forms of security are all relevant valuation factors.

From a UK valuation perspective, the question is what a willing, informed third-party purchaser would pay for the MIP shares. Where the MIP shares are identical to the shares being acquired by the private equity investor, the price paid by the private equity investor should provide a robust basis for determining the value of the ordinary equity acquired by the MIP participants (and, indeed, there is a "Memorandum of Understanding" between HMRC and the British Venture Capital and Private Equity Association ("**BVCA**") which, broadly, recognises this). As a consequence, in a simple private equity structure it is generally possible to ascribe low value to the ordinary equity providing that the share rights are equivalent for the management team and the private equity investor. By way of an example, it would not be unusual for the entire ordinary equity subscription to be subscribed for £1 million, with a typical management incentive pot of 10% (with no ratchet or other beneficial terms) costing £100,000, and with the bulk of the "equity investment" being provided by the private equity funds in the form of a loan note or preferred share (even if the £1 million being paid for the ordinary shares represent a tiny fraction of the overall equity commitment being made).

Having said this, where there are differences between the rights of the private equity investors shares and the MIP shares or, for instance, the MIP shares have a ratchet which could deliver 20%, 30% or more of disposal proceeds from a sale with a high return, this simple valuation will likely not be appropriate and significant value might be ascribed (or HMRC might argue that significant value should be ascribed) to the MIP shares. These circumstances, in particular, would merit a robust third-party valuation being obtained when any MIP shares were to be issued.

The tax valuation methodology used by the US and certain other jurisdictions can, as well as considering the current value of the MIP shares, bring into question whether the split between ordinary equity and a preference instrument is or is not an arms-length, commercially reasonable apportionment. Those alternative valuation methodologies tend to place less reliance on alignment of price between the private equity investor and the management team subscription for ordinary shares, and consequently can result in very different valuation outcomes. This in turn can lead to some significant challenges when trying to award shares on similar economic terms to internationally diverse management teams.

Tax elections

As one might expect, a key objective of the MIP is to preserve the value of the incentive by minimising tax leakage on acquisition of the MIP shares and, more importantly, on their future sale.

In most (although not all) jurisdictions, this means seeking to deliver capital gains tax treatment. To benefit from capital gains tax treatment on sale, tax elections will often need to be signed by the recipients of the equity (and their employer) where the individuals elect to be taxed under the employment income tax regime for any benefit in kind or undervalue element arising on the original issuance of the equity to them, with the benefit being that, on an ultimate exit, the exit proceeds themselves will be taxed under the capital gains tax regime.

However, the way in which such elections work in different jurisdictions can be materially different and can have vastly different consequences. For example, in the US, failure by the individual to sign their Section 83(b) tax election within 30 days of receipt of their shares, and to file that election with the IRS, will result in all proceeds being taxed as income (and any failure to do so is not easily capable of remedy). In contrast, in the UK, the relevant tax election (being a Section 431 tax election) need only be retained by an individual's employer entity or its advisers and is not filed separately with HMRC. Even if such an election is not entered into at all in the UK, it will only result in a portion of the exit proceeds being treated as income for tax purposes where the portion in question represents the percentage difference between what is called the "restricted market value" of their shares on original subscription and the so-called "unrestricted market value" of their shares at that time (which is generally considered by HMRC to be about 10–20%). If, however, the individual actually pays the unrestricted market value for their shares at the time of receipt, there is no "undervalue element" and therefore, notwithstanding the failure to sign the relevant tax election, the entirety of exit proceeds may still be treated as capital gains. It is generally advisable for elections to be signed, as that will simplify any future purchaser's due diligence and tax risk assessment on a future sale of the company.

Leaver provisions

The essence of the MIP is to encourage senior management to remain with the business up to and through a successful exit that returns cash value to the private equity owner. As such, for any individual who becomes a leaver it is currently typical for them to be liable to transfer back the entirety of their incentive equity, with the circumstances of leaving affecting the value received.

Categorisations of leavers range from, in the case of a position favourable to the private equity fund, simple categories of good and bad leaver (with good leaver being limited to individuals whose departure arises by reason of death, disability or who are, at the discretion of the investor, to be treated as a good leaver, with all other leavers designated as being deemed "bad"), through to the more management-friendly position of there being three categories of good, bad and intermediate leaver where intermediate leaver status includes termination of the individual's employment arrangements by the company other than for cause (and there are more complex formulations that may encompass concepts of very good, good, intermediate, bad and very bad leaver).

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Invariably, in the case of bad leavers, the typical treatment will be for any bad leaver to be required (by decision of the investor) to transfer their incentive equity interests either back to the company, or to an employee benefit trust for recycling to other new joiners, or directly to a new joiner, for consideration equal to the lower of the cost price of those equity securities and the fair market value of those equity securities (calculated either at the time the individual becomes a leaver or at the time of transfer). It is relatively rare for leaver provisions to apply negatively to the institutional strip securities held by managers who have reinvested proceeds in the target, but not unheard of; the most extreme provision we have seen recently dictated that a bad leaver would lose his or her investment for a pound (including their institutional strip securities which will have been acquired for substantial value). However, in this particular context, side letter provisions can be used to offset this treatment and savvy managers may thereby gain an advantage over their less experienced colleagues.

Vesting

For good leavers and intermediate leavers, the concept of time vesting normally applies so that depending on the period served with the company, the individual will receive fair market value for "vested" equity securities and the lower of cost price and fair market value for all "unvested" securities. In that regard, vesting will typically occur over a number of years from the date of the original transaction.

A typical vesting schedule would, for example, see 20% of an individual's equity "vest" for value purposes on the first anniversary of that individual receiving their shares, with a further 20% *per annum* vesting up to a maximum of 80% over the following three years. This means that even for a good leaver, full market value will not be realised for their stake unless the individual remains in post at the point of exit. Similarly, straight line vesting over five-year periods is not uncommon.

Vesting can occur on a "cliff" basis with an additional percentage vesting on each anniversary of the date of receipt of the relevant shares (or, in some cases, by reference to the anniversary date of the original transaction) or on a straight line basis throughout that period.

More rarely, ownership vesting will be permitted which will allow the individual to retain ownership of their vested proportion of equity. Whilst clearly advantageous to the individual (who will enjoy any future uplift in value to exit), this leaves both the private equity owner and the business with an element of the equity incentive pot that it cannot recycle and use to incentivise new joiners, in the event that a senior member of the management team leaves before exit occurs and, as a result, ownership vesting is present in a small minority of structures. In comparison, value vesting, which facilitates effectively recycling the shares held by the leaver, is a much more typical market construct. Ownership vesting, where it is found, tends to be a deal reserved for the founders of a business.

The fact that incentive equity held by certain leavers is transferable at the discretion of the investor is only helpful to the extent that the investor or the company is willing to pay out cash to the leaver at a time when no exit has occurred and no cash return is being made to the sponsor. Increasingly, private equity sponsors are taking the view that no such cash should be paid until an actual exit occurs based on the principle that an equity incentive arrangement is supposed to be a "cash-on-cash" incentive. Various different methodologies are being deployed to achieve this result including:

- **Loan notes**: In some instances the investor may require the incentive equity to be transferred in return for a vendor loan note or promissory note which will crystallise the value of the equity being transferred, but which will not trigger and pay out until an exit occurs. However, with investors' preference instruments increasingly taking the form of preference shares rather than shareholder debt, care needs to be taken as to how that vendor loan note or promissory note ranks. Being a debt instrument, unless specific provision is made, the vendor loan note or promissory note may take structural priority over the investor's preference instrument.
- **Capped value shares**: An alternative method has been to crystallise the value of the equity of the leaving individual at the point of their departure and at that point to create the concept of a capped value share where, until exit, the equity securities continue to be held by that individual and are sold for the lower of (i) the value of an uncapped ordinary share, and (ii) the capped amount. This structure has the benefit to the private equity sponsor of not requiring a cash payment to be made until exit arises (when cash is being paid to all shareholders); it also provides some downside protection so that if the value of the investment were to fall after an individual leaves the business, then the individual remains on risk for that value reduction. The disadvantage of the structure is that the management leaver will remain a shareholder in the ongoing business, which may complicate the ultimate exit process and make it more difficult for the seller to deliver a voluntary sale transaction where all shareholders directly sign up to a sale agreement. In addition, as referenced above under "*Drag and Tag*", there will now by definition be potentially multiple instances of shares which have different capped values – drag-along provisions need to be carefully crafted to allow for this or they may be ineffective. Also, maintaining confidentiality around an exit may be more complex because the network of individuals who will need to be contacted for such a voluntary sale arrangement to be organised will now include individuals who may have left the business a significant time ago, and may even be working with competitors. For example, what if the leaver is working for the potential buyer? We have seen these situations arise in the past and they are not always easily solved.

Drag and tag

Whilst MIPs are designed to align economic interests between private equity sponsors and the management teams, control over the exit process including both the method of exit and the time of exit rests squarely with the private equity investor. A drag right, which allows the private equity investor to require all shareholders to transfer their shares to an incoming buyer, is the key mechanism to support that ability for the private equity fund to drive the timing and method of exit as well as its execution. However, whilst all drag rights are intended to confer control over exit for the private equity house, many drag rights fail to appropriately deal with both the procedural requirements of an exit and with the valuation and waterfall payment nuances that typically arise. For example, a simple drag provision that requires all shareholders to sell on "the same terms and at the same price" may not operate on a valid basis where terms differ (which they invariably will on an exit as between the private equity financial institutional seller and the management team), and will almost certainly be invalidated where the value ascribed to different classes of shares under the company's constitutional documents are designed to vary. They may even be disrupted by agreeing to pay transaction bonuses to certain shareholders if those bonuses are not offered on an equivalent basis to dragged shareholders. Effective drag language therefore needs to

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carefully consider the payment waterfall under the company's constitutional documents, including any ratchet entitlement that will accrue to the incentive equity (see below) such provisions tend to operate most effectively when based squarely on statutory compulsory purchase and squeeze-out provisions (in the case of UK deals, being those set out in chapter 3 of Part 28 of the Companies Act 2006).

The inverse of a drag right and a material protection for management shareholders is a tag right. This ensures that where the private equity fund sells all or part of its stake to an independent buyer for value, then the rest of the shareholders have the right to sell a proportionate part of their own equity alongside them (thus giving management protection against being forced to partner with a new and potentially unknown investor).

Transfer restrictions

A MIP is designed to provide targeted incentives to certain members of the management team of the portfolio company and to ensure that those individuals only receive value as and when the private equity sponsor itself achieves a realisation of all or part of its stake for cash. As such, permitting transfer of management equity interests is fundamentally a "no go" area. Free transferability would both risk a disconnect arising between the holders of the incentive equity and the senior managers who it is designed to incentivise, and could also allow the realisation of value for that incentive equity at a time when the private equity fund itself has not received value in cash. Only very limited exceptions to the transfer restrictions are commonly found, with those exceptions allowing (if any) some limited capital gains and inheritance tax planning whereby interests may be transferred to family trusts or to other family members or controlled family companies. In all of those cases, however, if the key individual who is designated to receive the incentive leaves the company (whether of their own volition or otherwise), then the leaver provisions will still apply to all the equity interests whether or not they have been transferred or remain directly held. Similarly, if the transferee concerned ceases to be a permitted transferee then there is almost always a requirement that the relevant equity interests must be transferred back.

Ratchets

Many private equity sponsors take the view that for deals that truly out-perform their expectations as regards levels of return, they would be willing to share a greater percentage of the upside with management teams. The use of a ratchet mechanism which is embedded in the share rights constituting the incentive equity will typically be the method for achieving that. For example, where the initial management equity pot comprises 10% of the ordinary equity, it may be intended that management receive, for example, 15% of all equity proceeds in the event that the private equity house has achieved a return greater than 2.5 or 3 times its original investment.

The target triggering a ratchet may be based only on a money-on-money multiple or may also include an IRR hurdle with the result that both tests have to be met in order for the ratchet entitlement to arise. Following the financial crisis, when the investment hold period became elongated, more ratchets have been based purely on a money multiple basis than was the case beforehand when a double test was the market normal. In more recent vintages of incentive plan, as hold periods have again reduced, the double hurdle has made something of a comeback (although this may not necessarily be consistent with protecting the IRR (which is more likely to be protected in shorter investment cycles)). The ratchet entitlement itself may equally comprise a one-time adjustment (as in the simple example above) or may operate on a sliding scale so that as levels of return exceed various different targets, so the management's upside grows with that outperformance. In an environment where competition to win favour with a management team is high, the addition of a ratchet which gives away a share of "outperformance" may be an alternative and a relatively pain-free way of distinguishing one incentive proposal from another.

By embedding the ratchet entitlement in the share rights attaching to the incentive equity, the objective is to ensure that all the proceeds of sale are treated as capital gains in the hands of the management holders.

Where ratchets are used, they will invariably increase the market value of the incentive equity at the time that it is received by the management so that the cost of that incentive equity for tax purposes may be greater than a simple percentage of the total of ordinary share capital. For example, where the total ordinary share capital is to be issued for £1 million and the initial management equity policy is 10%, but a ratchet could result in management receiving 20% of equity proceeds above relevant targets, then rather than the management incentive equity being valued at £100,000 on issue (using UK methodology), instead the value might lie between £100,000–£200,000 (that is, between 10% and 20% of the ordinary equity value). For non-UK transactions and the many UK transactions that do not come within the scope of the model capital structure set out in the HMRC/BVCA Memorandum of Understanding, the valuation methodology may again look at a more fundamental assessment of the value of MIP shares (including the option value attaching to those shares), with the result that the initial upfront cost to management of receiving their equity incentive shares may be materially higher.

Other Areas to Consider

Succession arrangements

As businesses are increasingly maintained in private equity ownership for long periods of time, the situation where a management team may transition from one private equity owner to another has become increasingly common. Inevitably at some point in time, the original senior management team may wish to reduce their commitment to the business, both financially and in terms of time commitment, and transition their senior roles to new upcoming managers who will take the business forward.

Private equity houses have become increasingly adroit at handling questions of succession. In dealing with isolated and/or individual cases, a simple side arrangement may suffice to clarify expectations as to how and when transitions should occur and what the consequence will be for equity awards made to the outgoing senior manager. In other cases where succession is a broader issue, private equity houses have employed a number of innovative structures including "tranche value" shares to assist in succession planning. A tranched value share is a single class of share issued in tranches comprising different series, with each series having a cap on the maximum value it may receive. As such, where the value of the equity is increasing but there is a gradual transition of power and influence from one senior management team to another, different proportions of the value series may be issued to different individuals so the team who were initially responsible for taking the business forward from its original transaction value to the first stage of success will largely enjoy the fruits of their labours – whilst the

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incoming team who will increasingly take the burden of moving the business further forward to hopefully higher values and to ultimate exit, will themselves enjoy a greater proportion of those later phases of growth.

The challenge of widely held incentive plans

One of the key questions for both the private equity investor and the senior management team is how widely distributed the equity incentive pot will be. Very different philosophies exist in respect to that question with some views also impacted by reference to the nature of the underlying business. For a "people business" where individuals represent the revenue-generating assets of the business, and where those individuals are numerous, then the argument for a widely held equity incentive plan is clear. In other businesses, where the same dynamics do not apply, how wide to offer the incentive plan is often a subject of hot debate with one school of thought tending to the view that, to be meaningful and powerful, incentives need to be concentrated to deliver very significant value, and broadening the breadth of recipients merely has the effect of diluting the incentive effect for the small number of individuals who can really affect business performance. Tax considerations (including, for example, the availability of entrepreneurs' relief for individual MIP participants in the UK) may also mean that the management equity is tightly held (although the conditions for obtaining entrepreneurs' relief were significantly tightened in October 2018). If management is spread over a large number of jurisdictions, this can lead to further complexity and tension in the tax structuring of the MIP and its composition. It is rare for an international plan to deliver identical value to plan recipients once local taxes are taken into account. This in turn can cause tensions in the business, particularly if the workforce is highly internationally mobile.

Widely held equity incentive plans pose both administrative and structural challenges which require some additional thought (we have seen widely held plans which require around 400 hours of lawyer time per year to administer due to their size and complexity). By definition, there is bound to be greater fluidity in terms of both joiners and leavers where the plan is widely held. In addition, the individual investment appetite of the participants in the plan may vary significantly over the life of the plan. For example, where individuals become more senior and wish to increase their stake in the business as they feel they have more influence over driving an ultimately successful outcome. Similarly, some individuals may need to realise cash for their investment before an exit to meet personal financial needs. As well as constructing a method which allows for easy (typically electronic) communication with the wider body of shareholders, considering the use of nominees to limit the number of shareholders that need to be dealt with to satisfy corporate actions such as new issuances and other methods for simplifying administration of such a broadly held plan, consideration also needs to be given to whether to create some limited form of liquidity facility that allows individuals in the plan to rebalance their holdings from time to time. Those liquidity offerings can be more or less structured and may be as simple as an *ad-hoc* "matched bargain" system where individuals can specify whether they wish to increase or decrease their stake and, to the extent that mutual demand exists, the company may facilitate matching the demand with the supply through to more sophisticated regular liquidity rounds. These may operate in part on a matched bargain system and in part with the investor providing some limited liquidity, with more explicit rules around the maximum percentage of any individual's stake that can be monetised in any one round, the maximum permitted selldown during the life of an individual's investment and so on. In all such cases, more complex questions of securities legislation arise as the desire to create a liquidity system is effectively creating a market for the securities in question; all communications relating to the liquidity rounds, including from the company, will invariably comprise invitations to make an investment decision and such communications will necessarily be made to a broad group of individuals who will often be located in multiple jurisdictions.

In addition, where shares are being offered to wider numbers, careful consideration needs to be given to whether all the terms are necessary and workable. For example, having a share valuation method that works for a tightly held scheme could impose unbearable costs on the business in a widely held scheme if every leaver can request a share valuation. It may be desirable or preferable to simplify the plan terms for all other than the most senior managers (one example being that, rather than having multiple leaver status, the relevant equity documents may specify that any leaver simply gets repaid their money invested at the issue price – although adopting this approach would not be desirable in France, for example, where capital gains tax treatment requires the shares to carry valuation risk).

Challenges of Complexity

When one considers the possibility of a MIP comprising multiple classes of shares, some with ratchet entitlements, some of which are capped, some of which are uncapped and some of which may comprise hurdle or growth shares, it quickly becomes apparent that MIP arrangements can lead to substantial complexity. Whilst share registrars for large listed companies have developed robust tools and systems to handle the administrative challenge that this may bring, this is less common in respect of most private equity structures. Therefore, it is for the authors of MIP arrangements to consider how, as a practical matter, day-to-day corporate actions can be made to run smoothly including offers of new shares on a normal pre-emptive basis. Similarly, planning and delivering an exit can become more complex both as a matter of value allocation and in terms of the administration of a sale process. The blend of tax efficiency, commercial effectiveness and administrative simplicity remains the holy grail of incentive plans, and invariably one or more of those concepts suffer in the pursuit of the others.

In Conclusion

It seems likely that MIP structures will become increasingly complex and bespoke over the next investment period as bidders for valuable assets seek to distinguish themselves from their competition. To maintain competitiveness in this context, it is crucial that MIPs form part of the early discussions between bidders and their counsel and that management teams have access to sophisticated advisers who can assist them with navigating through the complex and sometimes convoluted world of the MIP.

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Rob is consistently recognised in *The Legal 500* and other leading directories.

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Alternative Exits: Legal and Structuring Issues in GP-Led Secondaries

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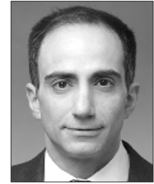

I. Introduction

Secondary deals led by financial sponsors ("GP-led Secondaries") hit the $22 billion mark last year, the highest figure ever recorded.[1] These deals, which constitute a growing subset of the $72 billion secondaries market,[2] are drawing ever-larger commitments, with transaction volume 38% higher in 2018 than in 2017.[3] As this chapter explains, GP-led Secondaries take a variety of forms; but at their core, these are transactions sponsored by general partners ("GPs"), financed primarily by secondary buyers ("Buyers") and designed to create a liquidity option for existing investors ("Existing LPs"). Although these transactions originated as a solution for illiquidity in portfolios reaching the end of a fund's life, GP-led Secondaries have evolved into a creative solution for proactive portfolio management. GP-led Secondaries can provide the following benefits for GPs, Existing LPs and Buyers alike:

- First, GP-led Secondaries can provide **a liquidity option** for Existing LPs who depend on that liquidity – for example, either to invest elsewhere or otherwise meet their current or near-term obligations. Existing LPs who would rather decline this liquidity option and remain invested ("Rollover LPs") can roll over into the new structure, often on mostly *status quo* terms, as further described below.
- Second, GP-led Secondaries can **extend the amount of time** that a GP has to realize existing assets. This realigns the investment horizon with the reality of the asset and its prospects, rather than preexisting fund terms. It allows the GP to continue managing its existing assets, and to maximize the value of such assets, while simultaneously providing Existing LPs with the necessary liquidity.
- Third, GP-led Secondaries can **re-incentivize the GP** with a new or extended fee stream and a reset of carried interest.
- Fourth, GP-led Secondaries can be **attractive for Buyers**, providing an ability to diligence the assets being indirectly purchased and allowing the GP, who is familiar with these assets, to continue managing the assets.

A challenge that consistently arises in these situations is how to provide an outcome that works for all stakeholders involved. Accordingly, different transaction structures have emerged, each with its own advantages and drawbacks.

This chapter proceeds in two parts. First, it explores those transaction structures in broad terms, including certain legal considerations raised. Second, it discusses the myriad conflicts of interest inherent in all GP-led Secondaries with some suggestions for conflict mitigation.

II. Interest Tenders *vs.* Fund Recapitalizations

In broad terms, there are two distinct flavors of GP-led Secondaries: (1) a tender offer for the Existing LP's fund interests (an "LP Tender"); and (2) a fund recapitalization (a "Fund Recap"). This section provides an overview of each, and it addresses key advantages and drawbacks of each.

A. LP Tenders

In an LP Tender, the sponsor solicits offers from one or more Buyers to tender for all, or a significant portion of, the Existing LP's interests. Then, with the consent of the sponsor, one investor (i.e., the Existing LP seller) is essentially swapped out for another (i.e., the Buyer). The tender offer construct would typically also be combined with a vote to extend the fund term and an agreement between the GP and the Buyer regarding a new management fee and carried interest arrangement.

With LP Tenders, the sponsor and its counsel must carefully decide whether a proposed transaction would likely be deemed a "tender offer" under the U.S. securities laws or any other applicable jurisdictions.[4] This section explores the U.S. tender offer rules as they relate to private offerings, with an emphasis on the advantages and drawbacks of pursuing this structure in the context of a GP-led Secondary.

"Tender offer" is not a defined term in the U.S. securities statutes or regulations. However, courts have examined the question of whether and when a tender offer is deemed to have occurred by applying multifactor tests to the particular facts and circumstances of a given transaction.[5] One frequently cited formulation was first set forth in *Wellman v. Dickinson*, where the court identified the following factors (not all factors must be present for a court to find that a tender offer exists):

- whether there is an active and widespread solicitation to purchase the securities;
- whether the solicitation is made for a "substantial percentage" of the securities;
- whether the terms of the offer are firm and not negotiable;
- whether the offer is open only for a limited time period;
- whether the offer is at a premium to prevailing market prices;
- whether the offer is contingent on the tender of a fixed number of securities; and
- whether there is pressure on the existing security holder to sell.

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Based on an evaluation of these factors, if the sponsor and its counsel believe that the transaction could be deemed a tender offer, then the private tender offer rules must be complied with, including the following:

- the offer must be held open for at least 20 business days;
- if the percentage of interests being offered, or the consideration being sought, is increased or decreased, then (i) notice of such increase or decrease must be provided, and (ii) the offer must remain open for at least 10 business days from the notice date;
- the parties must promptly pay the consideration or return the tendered securities, upon termination or withdrawal of the offer;
- the offeror must give notice of the extension of a tender offer, which must include disclosure of the amount of securities already tendered; and
- the issuer must disclose its position with respect to the offeror's tender offer.[6]

Additionally, several anti-fraud and anti-manipulation provisions still apply (e.g., Section 14(e) of the Securities Exchange Act of 1934).

Several additional rules, which arise in the context of public tender offers, do not apply to private tender offers. For example, such offers need not comply with the proration, best price and all holders' rules that apply to offers to purchase public securities. Non-U.S. tender offer rules may also apply, and accordingly, sponsors should consult with local counsel when a particular deal involves non-U.S. buyers or sellers.

There are a number of advantages to pursuing the LP Tender structure in a GP-led Secondary. A tender offer is the simplest form of GP-led Secondary, and accordingly, it is often the fastest option. The transferee's identity is pre-approved by the sponsor, and diligence is primarily focused on the price of the fund's assets. Given the fact that the fund's assets are not being transferred, there may be no need to diligence the transfer restrictions that may apply to such assets. Additionally, there are typically fewer complicated renegotiations – for example, LP Tenders may not require the formation of a buyer vehicle and may not trigger carry crystallization events.

There are also some drawbacks to pursuing an LP Tender. First, it does not provide the same opportunities for custom tailoring the deal to fit the Buyer's specific needs – for example, it can be difficult to find Buyers willing to purchase exposure to the fund's entire portfolio or assume fund interests from existing investors with a variety of tax profiles. Second, there is no actual realization event for the assets – in other words, interest tenders do not produce carried interest distributions to the GP or crystallization of clawback liabilities from the GP. And third, sponsors and their counsel must carefully evaluate – and potentially navigate – certain tender offer rules that may apply, as discussed above.

Finally, there are a couple of complicating factors that sponsors should keep in mind when considering whether to pursue an LP Tender. First, the sponsor may wish to negotiate additional terms with the Buyer. For example, the sponsor could seek to extract a higher management fee or supplemental carried interest. This may be achieved through a side letter or by funneling the Buyer's investment through a feeder vehicle. Second, the Buyer may agree to new capital commitments for follow-on investments and Existing LPs that roll over may be given the option to participate in the additional investments on *pari passu* terms with the Buyer. These features can lead to meaningful complications, as described further below.

B. Fund Recaps

What LP Tenders provide in terms of speed and simplicity, they lack in terms of flexibility. Fund Recaps, on the other hand, are bespoke transactions – and importantly, Fund Recaps can be limited to one, or a subset of, the fund's assets. This section begins with the common features of Fund Recaps before exploring a couple of common structures, which are illustrated by example structure charts. Finally, it considers the advantages and drawbacks of pursuing a Fund Recap, which generally reflect a reverse image of the LP Tender.

Fund Recaps generally involve the sale or contribution of all, or a portion of, the assets of the existing fund (the "Existing Fund") to a new legal entity (the "Continuation Vehicle"). The Continuation Vehicle is capitalized by the Buyer, and it is managed by the Existing Fund's sponsor. Given their bespoke nature, Fund Recaps provide Buyers with an opportunity to negotiate extensive new terms and invest incremental capital, which can fund follow-on investments in existing assets or new investments in complementary assets.

Fund Recaps present two options for Existing LPs: they can "cash out" of the existing fund structure; or they can roll over into the Continuation Vehicle on the basis of the Existing Fund's terms (although, typically with a longer term). Under the latter option, it is important that sponsors preserve, to the extent possible, the *status quo* for Rollover LPs, especially with respect to economic terms.

There are a number of advantages to pursuing a Fund Recap. First, Fund Recaps are more flexible than LP Tenders – for example, they provide the ability to surgically carve-out an asset, or assets, from the transaction, and they allow the GP and the Buyer to negotiate new terms through the Continuation Vehicle's fund documents. Second, to the extent the Existing Fund is in "carry mode" a Fund Recap can crystallize carried interest for the sponsor with respect to the Existing LPs who elect to sell ("Selling LPs"), all or a portion of which may be rolled over to the Continuation Vehicle. Additionally, the transaction may de-risk, or shift the economic burden of, existing clawback obligations.

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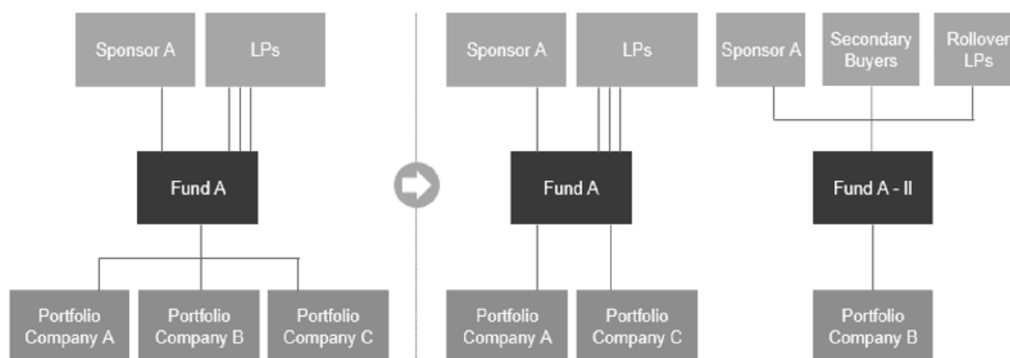
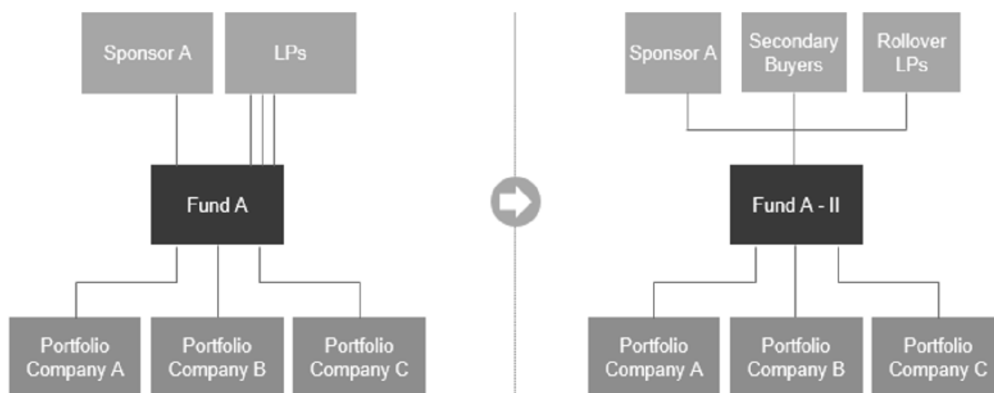
Figure A. **Single Asset Sale**



Transaction Summary: This transaction represents a Fund Recap structure for a single asset sale. Prior to the Fund Recap, Fund A, which is managed by Sponsor A, holds interests in Portfolio Companies A, B and C. In the Fund Recap, Portfolio Company B is carved out of Fund A and placed in a Continuation Vehicle ("Fund A-II"). Sponsor A continues to manage Portfolio Company B, through Fund A-II, and the deal is capitalized by the Buyers. LPs from Fund A are given an option either to receive liquidity (i.e., proceeds from Fund A's sale of Portfolio Company B) or roll over into the Continuation Vehicle, which provides LPs with continued economic exposure to the performance of Portfolio Company B.

Figure B. **Whole Portfolio Sale**



Transaction Summary: This transaction represents a Fund Recap structure for a whole portfolio sale. Prior to the Fund Recap, Fund A, which is managed by Sponsor A, holds interests in Portfolio Companies A, B and C. In the Fund Recap, each of the Portfolio Companies is placed in a Continuation Vehicle ("Fund A-II"). Sponsor A continues to manage the whole portfolio, through Fund A-II, and the deal is capitalized by the Buyers. LPs from Fund A are given an option either to receive liquidity (i.e., proceeds from Fund A's sale of the Portfolio Companies) or roll over into the Continuation Vehicle, which provides LPs with continued economic exposure to the whole portfolio.

There are also some drawbacks to pursuing a Fund Recap. First, these custom-tailored transactions are more complex than LP Tenders – for example, Fund Recaps require organizing a Continuation Vehicle structure and negotiating a new suite of fund documents. Second, these negotiations are typically more extensive than LP Tenders, as they present more opportunities to reset fund economics and governance. Third, Fund Recaps involve the actual movement of assets. Therefore, more extensive due diligence is typically conducted – for example, legal inquiries around transfer restrictions and change of control are common. Finally, Fund Recaps require the sponsor to sit on both sides of the transaction (i.e., the Existing Fund and the Continuation Vehicle) in a more prominent manner (although the fundamental conflicts are similar to those found in LP Tenders as well). Accordingly, such transactions are more susceptible to potential conflicts of interest, which sponsors and their counsel must carefully identify and mitigate. The following section addresses such conflicts and potential mitigation techniques.

III. Conflicts of Interest

A. Potential Conflicts

A number of potential conflicts of interests exist in all GP-led Secondaries. First and foremost, there is the selling price conflict. As the GP of the Existing Fund, the sponsor owes fiduciary duties to Existing LPs, with a goal of price maximization. Here, the opportunity to crystallize carry or mitigate a potential GP clawback aligns the sponsor's interest with that of the Selling LPs' goal of price maximization.

At the same time, the sponsor generally receives new economics from the Continuation Vehicle, which incentivizes the sponsor to negotiate for a lower price in order to increase the likelihood of closing the transaction. Additionally, if the Existing Fund is not in "carry mode", resetting the carry, through the Continuation Vehicle to the purchase price, incentivizes the sponsor to negotiate for a lower price. Finally, as the GP of the Continuation Vehicle, the

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sponsor is usually required to roll over most, if not all, of its equity investment. Therefore, the sponsor typically is not directly affected by the purchase price because the sponsor is a fiduciary to both the Existing Fund and the Continuation Vehicle; these conflicts do not offset one another, but rather, the sponsor has two independent conflicts, each of which must be resolved.

In addition to the selling price conflict, sponsors and their counsel should examine the following deal features, which tend to give rise to additional conflicts of interest that require careful attention and mitigation:

- Extending term.
- Resetting carry.
- Realizing carry.
- "Converting" carry into equity or an "equity-like" instrument.
- Additional management fee from the Continuation Vehicle.
- "Stapled" deals (i.e., where Buyers' participation in the GP-led Secondary is conditioned on a pledge of additional fresh capital to the firm's latest fund).[7]
- Creating longer relationships with Rollover LPs.
- Providing a liquidity option for Existing LPs.
- Setting up a mark for illiquid investments.
- Incurring expenses, including broken-deal expenses.
- Avoiding out-of-pocket exposure for accrued clawback.

There are various ways to mitigate these conflicts. The following section describes several "best practices" with respect to conflicts mitigation, although it is intended to be illustrative rather than exhaustive.

B. Best Practices and Conflict Mitigation

Sponsors should engage with LPs and the LPAC early in the process, in order to provide a rationale for the transaction, as well as any strategic alternatives considered. In doing so, the sponsor should consider sensitivity around disclosing the names of potential Buyers and the appropriate timing for such disclosure. Generally, according to ILPA recommendations,[8] the appropriate lead time for a GP-led Secondary transaction should be no less than six months before expiration of the term of the fund or the fund extension, as applicable.

To alleviate concerns around the selling price conflict, sponsors routinely engage an independent financial advisor to conduct a strategic bidding process and arrive at a valuation range, particularly when the transaction involves a significant number, or size, of assets. In some cases, the GP may decide that the independent financial advisor, which is typically unaffiliated with the financial adviser running the bidding process, should render a fairness opinion.

Another route to mitigate the conflicts of interests relating to GP-led Secondaries is to seek consent from the Existing Fund's LPAC. When seeking LPAC consent, sponsors generally include a description of the bidding process, including details regarding the final two or three highest bids, along with other key terms of the transactions, including proposed expense allocations, while highlighting key conflicts. Commonly, the LPAC will not approve the transaction or opine on the purchase price, but rather merely provide a waiver of the conflicts of interests. Finally, as mentioned before, sponsors frequently provide each of the Existing LPs with the option to elect whether or not to participate in the transaction. In the election process, the sponsor should aim for transparency and information parity (including access to data rooms, etc.), to the extent possible, *vis-à-vis* the information provided to the Buyer. In doing so, the sponsor should consider whether and how to disclose:

- financial information relating to the fund's remaining assets;
- any pricing discount, including to the most recent valuation, reflected in the proposed transaction and any actual or expected material changes;[9]
- the sponsor's conflicts and the actions taken to mitigate such conflicts (including information relating to the price discovery process);
- the key terms of the transaction, such as the economics the sponsor is receiving (e.g., new management fee, new carry or resetting carry, crystallization of carry, rollover carry, allocation of expenses);
- the allocation of transaction-related fees and expenses between the Buyer, the sellers, the Rollover LPs and the GP;[10]
- all relevant fees and expenses, including broken-deal expenses and the impact of fees on carry; and
- with respect to Rollover LPs, the sponsor should also disclose the key changes *vis-à-vis* their existing terms and aim to provide a *status quo* option, to the extent practical. To that end, Rollover LPs should not be compelled to participate in any additional follow-on capital commitments and any resulting dilution of Rollover LPs should be done on a fair and reasonable basis.

The election process should be held open for a period of reasonable duration – ILPA suggests 30 calendar days (or 20 business days), which is in line with the private tender offer requirements.[11] To the extent that the Buyer received access to portfolio management, the sponsor should consider whether LPs should receive the same access. As a conflict mitigation tool, it is helpful if a majority of Existing LPs either sell or approve the transaction.

IV. Conclusion

As this chapter has explained, GP-led Secondaries have become an important fixture in the private equity market for reasons favorable to both GPs, LPs and Buyers alike. While this growing subset of the market continues to mature, sponsors and their counsel should understand the various potential structures at their disposal and the important legal and regulatory issues at play, particularly with respect to conflicts of interest.

Endnotes

1. Chris Cumming, *GP-Led Secondaries Hit Record $22 Billion Last Year*, *WSJ Pro* (Feb. 15, 2019).
2. *Id.*
3. *Id.*
4. Not all repurchases or third-party secondary purchases of private company stock are deemed tender offers for purposes of the U.S. securities laws. Instead, many transactions are simply individually negotiated transactions.
5. *See*, e.g.: *SEC v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945, 950–52 (9th Cir. 1985) (issuer's repurchase of shares on open market did not constitute tender offer under multifactor test); *Polinsky v. MCA, Inc.*, 680 F.2d 1286, 1291 (4th Cir. 1982) (open-market and privately negotiated purchases did not constitute tender offer under multifactor test); *University Bank and Trust v. Gladstone*, 574 F. Supp. 1006, 1010–11 (D. Mass. 1983) (private solicitations did not constitute tender offer under multifactor test); *Zuckerman v. Franz*, 573 F. Supp. 351, 358 (S.D. Fla. 1983) (cash merger proposal did not constitute tender offer under multifactor test); *Astronics Corp. v. Protective Closures Co., Inc.*, 561 F. Supp. 329, 334–

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36 (W.D.N.Y. 1983) (private sale held not likely to constitute tender offer under multifactor test); *Ludlow Corp. v. Tyco Labs, Inc.*, 529 F. Supp. 62, 67 (D. Mass. 1981) (open-market and privately negotiated purchases did not constitute tender offer under multifactor test); *Wellman v. Dickinson*, 475 F. Supp. 783, 823–26 (S.D.N.Y. 1979) (privately negotiated purchases constituted tender offer under multifactor test), *cert. denied*, 460 U.S. 1069 (1983); *Hoover Co. v. Fuqua Indus., Inc.* [1979–1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) 97,107, at 96,150 (N.D. Ohio 1979) (private solicitations constituted tender offer under multifactor test). But *see Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47, 57 (2d Cir. 1985) (criticizing multifactor test as not consistently determinative of whether activity constitutes tender offer); and *Brascan Ltd. v. Edper Equities Ltd.*, 477 F. Supp. 773, 791 (S.D.N.Y. 1979) (finding multifactor test undesirable because of test's unpredictability).

6. The issuer (i.e., the GP) may take the view that its position on the offer is neutral, and that each Existing LP should make its own investment decision, which can help mitigate potential conflicts, as discussed further in Part III.
7. In 2015, the U.S. Securities and Exchange Commission (the "SEC") announced it would be examining such "staple" transactions with heightened scrutiny. These transactions are beneficial for sponsors because they provide additional investors in the sponsor's new fund, attracting fresh dry powder and a new fee stream. In that regard, the SEC is concerned that sponsors may tend to undervalue the secondary transaction sale price, in order to make the deal more attractive to the Buyer, at the expense of the Selling LPs. *See* Dawn Lim, *SEC Zeroing in on Stapled Secondary Deals*, *Wall St. J.* (Jun. 18, 2015).
8. "ILPA" is the Institutional Limited Partners Association, a trade organization for institutional limited partners in private investment funds. In April 2019, ILPA released recommendations on the practice of GP-led Secondaries. The guidance is available at https://ilpa.org/wp-content/uploads/2019/04/ILPA-Guidance-on-GP-Led-Secondary-Fund-Restructurings-Apr-2019-FINAL.pdf.
9. For example, in September 2018, Veronis Suhler Stevenson ("VSS") settled with the SEC over failing to disclose its latest valuation during a GP-led Secondary process, in which the net asset value of the fund and the EBITDA of the fund's two assets had risen subsequent to the offer letter furnished to Existing LPs. *See* VSS Fund Management LLC, Investment Advisers Act Release No. 5001 (Sept. 7, 2018).
10. ILPA notes that, in cases where the GP clearly benefits from either additional fee revenue or through a stapled commitment, the GP could consider sharing some portion of the transaction costs. *See supra* at 8.
11. *Id.*

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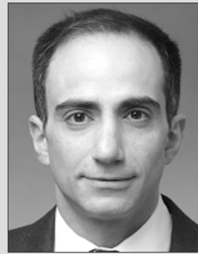

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EU Sustainable Finance Rules Start to Affect Private Equity

British Private Equity & Venture Capital Association (BVCA)

Tom Taylor

"The Task is Large, the Window of Opportunity is Short, and the Stakes are Existential"

The integration of environmental, social and corporate governance (ESG) issues in private equity reporting and investment processes is not a new phenomenon. The BVCA published its first *Responsible Investment Guide* back in 2012, and the UNPRI followed suit in 2014, with its guidance on *Integrating ESG in Private Equity*. These are just two of many milestones marking ESG's steady progress towards mainstream industry practice over the past decade or more. Now, in early 2019, government intervention is beginning to pick up the pace.

Some of the new legal and regulatory activity has been domestic. The UK Government has recently pursued a more ambitious programme of policy intervention, delivered in parallel across the "E"; the "S"; and the "G". Rules governing the "G" are evolving via a range of UK corporate governance reforms (2018 was a bumper year for consultations in that space) aimed at re-building public trust in business after the financial crisis and some high-profile corporate failures. These reforms tend to be more relevant to investors in public companies, partly because the governance of unlisted companies is already one of private equity's recognised strengths. The "S", too, has recently drawn increased attention from UK policymakers, leading to new legal frameworks targeting various social issues like modern slavery and the gender pay gap. Finally, the "E" has witnessed the 'replacement' of the Carbon Reporting Commitment with the Streamlined Energy and Carbon Reporting framework.

Increasingly though, it is the co-ordinated action of international policy actors relating mostly to the "E" and, to a lesser extent, the "S", that are bringing regulation of the full trinity of ESG (or "sustainable finance") to the fore. The policy objectives of the 2016 Paris Agreement and UN Sustainable Development Goals (SDGs) are beginning to crystallise into hard rules, such as the FCA's Climate Change & Green Finance proposals (consulted on in January 2019), and the first elements of the EU's sustainable finance reforms (approved by the European Parliament in April 2019). The G20 has added parallel impetus, specifically on climate-transparency, via the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TFCD), references to which now commonly adorn government consultations and public debate.

Perhaps one of the surest examples of international regulatory co-operation on sustainability is the emergence of the Network of Central Banks and Supervisors for Greening the Financial System (NGFS), established in 2017. When the Bank of England's Mark Carney says of climate finance policy that "*the task is large, the window of opportunity is short, and the stakes are existential*", it is relatively safe to assume that regulatory change is coming. This article sets out the key areas, at EU level, where politics and policy are beginning to harden into concrete regulatory changes that will affect private equity firms.

The Foundations of EU Sustainability Policy

The EU believes the financial sector is key to the world's efforts to reach the climate and sustainability targets laid down in 2016's Paris Agreement and the UN Sustainable Development Goals. It credits the financial services industry with the ability to: re-orient capital towards more sustainable businesses; encourage a more sustainable way of financing growth; and help create "a low-carbon, climate resilient and circular economy".

The EU's sustainable finance policy is based largely on the European Commission's action plan on sustainable finance, which itself comes from a set of recommendations by the EU's High-Level Expert Group on Sustainable Finance that began work in 2016. The action plan covers many areas of financial services, and has spawned a wide-ranging package of legislative proposals that the Commission announced in May 2018.

For private equity, two key elements of the 2018 package took a clearer form in April 2019. These are: a new regulation on sustainability-related disclosures (the "Disclosure Regulation"); and some targeted technical advice from ESMA on how the AIFMD and MiFID II regulatory regimes should be amended in order to integrate "sustainability risks" and "sustainability factors" into AIFMs' and MiFID firms' businesses.

The Disclosure Regulation

The Disclosure Regulation reached political agreement in April 2019. It imposes obligations on regulated firms to: (a) disclose publicly how they integrate sustainability risks (ESG events that could adversely affect the value of an investment) in their processes; and (b) ensure investors receive meaningful information on how sustainability risks could affect the value of their investments and the performance of any sustainability-focused investments. The aim is to force consistent disclosures, which should allow investors to make more effective ESG-based investment decisions.

Broadly, the Disclosure Regulation will oblige AIFMs, MiFID firms and EuVECA managers to:

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(i) Publish sustainability information on their website, including an explanation of their policies on the integration of sustainability risks in their processes, and of how their remuneration policies are consistent with the firm's integration of sustainability risks. Firms will be required to keep this information up-to-date, and if the information changes, to include a clear explanation of the reason for the change.

(ii) Publish information on whether the firm considers the principal adverse impacts of investment decisions (or investment advice) on ESG matters, respect for human rights, anti-corruption and bribery. This applies on a comply-or-explain basis, and proportionately, i.e. the requirement is subject to individual firms' size, nature, scale of activities and the types of financial products they deal with. The option to explain (rather than comply) will cease 18 months after the Disclosure Regulation comes into force for firms (or firms within groups) that have 500 or more employees.

(iii) Include sustainability-related risks in pre-contractual disclosures (e.g. AIFMD Article 23 disclosures in PPMs) and ongoing reporting to investors, including pre-contractual disclosure of how the firm integrates sustainability risks into its management or advisory processes, and the likely impact of sustainability risks on financial returns. Again, this is on a comply-or-explain basis (with the exception of sustainability-focused products, see below).

(iv) Disclose further information in relation to sustainability-focused financial products, including: (a) publicly disclosing a description of the sustainability objective of the product and methodologies used to assess it (which raises financial promotion issues); and (b) disclosing the sustainability impact of the product in periodic reports. These disclosure obligations will be subject to detailed requirements and methodologies (to be developed in future regulatory technical standards).

Much of the detail regarding the content, methodology and presentation of the new sustainability disclosure requirements will be set out in future technical standards after the regulation comes into force. The regulation itself should apply from 15 months after its publication in the Official Journal of the EU, which should occur later this year.

Proposed Amendments to AIFMD

ESMA delivered a report (30 April 2019), at the request of the Commission, on how the AIFMD Level 2 provisions (the AIFM Delegated Regulation[1]) could be amended in order to promote sustainable finance. The report covers AIFMs' organisational requirements, operating conditions and risk management processes. The 2019 EU elections will have altered the Commission's political makeup by the time it reacts to ESMA's advice, and there is no guarantee that the Commission will fully agree with the regulator's approach. However, the report gives a strong indication of the direction of travel.

ESMA's general approach

ESMA's proposals reflect the Disclosure Regulation. The suggested amendments connect closely with it, particularly via key definitions such as "sustainability risks" and "sustainability factors", and ESMA calls for any changes to AIFMD and MiFID to apply from the same date as the Disclosure Regulation. This reflects the broader policy aims of encouraging convergence and avoiding duplicative or conflicting rules, a common industry concern as various sustainability regimes develop in the EU and elsewhere.

Private equity firms, particularly those that have created their own bespoke ESG procedures, will be pleased that ESMA's proposals are principles-based rather than prescriptive. This is partly a practical response from ESMA to the fact that regulation of ESG and sustainability is in its infancy, remains hampered without a common taxonomy and reliable data, and is evolving from several sources at once. For ESMA to be too prescriptive at this stage would be premature, although it has not ruled out more detailed Q&A in due course.

Smaller firms in particular, will be reassured by ESMA's commitment to the proportionality principle, meaning the measures firms will have to implement to meet any new requirements are likely to vary according to the size (and resources) of individual firms.

"Organisational requirements" of AIFMs

A number of ESMA's proposals would affect AIFMs' internal organisation. Article 22 (*Resources*) of the AIFM Delegated Regulation would make AIFMs "*take into account the necessary resources and expertise for the effective integration of sustainability risks*[2]" when considering whether they had sufficient people and skills to comply. ESMA also suggests, under Article 57 (*General requirements*), that AIFMs should "*take into account sustainability risks*" when complying with existing requirements on decision-making, training, internal controls, reporting and record keeping.

BVCA member firms were concerned that these changes could lead AIFMs to conclude that they needed to hire a dedicated sustainability expert(s), and that sustainability risks might be elevated above other types of risk. One cumulative effect of this, as well as imposing potentially unmanageable burdens on smaller firms, could have been to separate the consideration of sustainability risks from other types of risk, rather than integrating ESG more holistically within the investment process.

The risk of sustainability becoming compartmentalised in this way has receded because ESMA's final advice explicitly states that firms should not have to hire or designate a specific individual (e.g. a Chief Sustainability Officer) "at this stage". Its proposals would instead leave "senior management" collectively responsible for integrating sustainability risks and ensuring that individual firms had, as a unit, the skills, knowledge and expertise to manage those risks. This is particularly welcome news for small and mid-sized firms that may not have the resources to hire a dedicated sustainability expert, but also for the market as a whole, given concerns around the size of the available ESG talent pool. It may also reduce the likelihood of firms seeing ESG issues as part of a mere box-ticking exercise.

"Operating conditions" for AIFMs

To address sustainability considerations raised by conflicts of interest, ESMA has proposed a new recital to the AIFM Delegated Regulation. This would require AIFMs to consider what conflicts "*may arise in relation to the integration of sustainability risks*" as part of their general conflict identification processes. Following industry feedback, the proposals give examples of where sustainability conflicts may arise,[3] although it remains unclear whether this would expand conflict management beyond AIFMs' existing systems. ESMA has also invited the Commission to avoid giving "*excessive prominence to conflicts arising in relation to Sustainable Finance over other sources of conflicts of interest*", which again accords with industry feedback.

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ESMA's report proposes sustainability-driven changes to the rules governing due diligence on fund investments, and an additional paragraph under Article 18 (*Due diligence*):

> "5. *AIFMs shall take into account sustainability risks and, where applicable, the principal adverse impact of investment decisions on sustainability factors when complying with the requirements set out in [existing due diligence rules]. Where applicable, AIFMs shall develop engagement strategies including for the exercise of voting rights, where available, with a view to reducing the principal adverse impact of investee companies on sustainability factors.*"

It is clear from ESMA's accompanying narrative that it would expect firms to take a principles-based approach to integrating sustainability risks and factors into due diligence processes "at this stage". ESMA expressly rejected calls from some quarters to provide more detailed guidance on how due diligence requirements should be applied in practice, and feels it is clear that firms could apply proportionality. Again, the report does not exclude more granular rules in the future, and the BVCA will continue to monitor this closely.

AIFMs' risk management policies

ESMA's technical proposals on risk management simply state that sustainability risk should feature on the list of risks AIFMs are required to manage under Article 40 of the AIFM Delegated Regulation. This approach accords with BVCA members' feedback during consultation and should allow firms to continue integrating the consideration of ESG factors in holistic ways that fit each firm's individual, existing investment strategies, processes and operational infrastructure, rather than forcing a drastic structural re-think or encouraging AIFMs to view compliance as an ineffective box-ticking exercise (at least for now). Interestingly, ESMA acknowledges that there are significant "operational challenges" for firms in securing reliable sustainability data, which is notoriously hard to come by, but believes that firms should be able to use proportionality to comply, for example in the current environment where reliable sustainability information is relatively scarce.

Similar Principles Lie Behind ESMA's Proposed Amendments to MiFID II

Unsurprisingly, ESMA has taken much the same approach for MiFID firms. The regulator proposes a flexible, principles-based and proportionate approach to integrating sustainability risks and factors into MiFID firms' conflicts of interest and risk management procedures, whilst leaving the door open to more detailed requirements in the future, via regulatory Q&A.

ESMA's advice on amending the MiFID II Delegated Regulation[4] is limited to firms' organisational requirements and the product governance rules. The proposed changes to Article 21 (*General organisational requirements*) would simply require firms to "take into account" ESG considerations as part of their internal operations when providing investment services to clients (or establishing risk management procedures under Article 23). Helpfully, following industry feedback, firms would only be obliged to consider ESG considerations "where relevant". The proposed amendments to the product governance rules, though less important for private equity firms, on the whole, continue the themes of flexibility, proportionality and relevance.

The Future

The industry can take some reassurance from the current landscape of EU regulatory change in this area. It seems possible that private equity fund managers and investors, in the medium term at least, may retain much of their current freedom to agree amongst themselves on how sustainability factors should be integrated into investment and reporting processes (subject to upcoming technical standards). This is important, given that different fund managers have different internal organisational structures, investors, investment strategies, philosophies and geographical outlooks.

However, ESMA will increasingly expect firms to show they are considering sustainability issues, and to disclose enough information to allow investors to shop around on the basis of ESG performance, should they wish to (and should reliable data be available). There is also political consensus within the EU that sustainable finance should remain a political priority for the foreseeable future. Further change is therefore close to inevitable.

Endnotes

1. Commission Delegated Regulation (EU) 231/2013.
2. "Sustainability risks" are defined in the European Parliament's final position on the Disclosure Regulation as "*an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment arising from an adverse sustainability impact*".
3. "*The identification process should include, for example, conflicts arising from remuneration or personal transactions of relevant staff as well as any sources of conflicts that could give rise to greenwashing, misselling, misrepresentation of investment strategies or churning. Consideration should also be given to conflicting interests between funds with different investment strategies managed by the same AIFM as well as situations where there are other business-relationships with investee companies, conflicting group interests, investments in entities with close links or similar circumstances*" (ESMA's final report on integrating sustainability risks and factors in the UCITS Directive and the AIFMD).
4. Commission Delegated Regulation (EU) 2017/565.

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The British Private Equity & Venture Capital Association (BVCA) is the industry body and public policy advocate for the private equity and venture capital industry in the UK.

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Australia

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

Buyouts constitute the most common type of private equity (**PE**) transaction in Australia, with Australian buyout funds accounting for more than six times the assets under management (**AUM**) of growth, balanced, co-investment, direct secondaries and turnaround funds combined. Buyouts generated 79% of total new fund commitments raised for PE and venture capital in 2018.

The current high levels of dry powder amongst PE funds have not been seen since December 2011. The Australian Investment Council (**AIC**) recently reported that investment activity rebounded in 2018, with the number of buyout deals slightly up (to 75 for the year) and aggregate value up a sizeable 89% (to $12.5 billion) compared with 2017, which had the second lowest number of transactions in the previous 10 years.

There has also been a slight recovery in the aggregate value of exits completed, from $8.1 billion in 2017 to $9.2 billion in 2018. Fewer PE-backed IPOs were also recorded than in previous years, with only nine recorded in 2018 and four in 2017 (with all nine 2018 IPOs finishing the year lower than their listing prices). PE managers often run a "dual-track" exit process, but are more commonly opting for trade sale exits, culminating in a record 73% of buyout exits conducted by way of trade sale in 2018.

The last two or three years have also seen more co-investment opportunities being sought by superannuation (pension) and sovereign wealth funds. These opportunities prove attractive to such funds which have the bandwidth and experience to be involved in the management of such investments, while offering exposure to the PE sector and limiting the management and performance fees that would otherwise be imposed. From the perspective of PE funds, this reduces the need for "club deals" with other PE funds for larger acquisitions and gives small- and mid-cap PE funds exposure to larger deals than would normally be available to them. Recent high-profile examples of such co-investments include AustralianSuper teaming up with BGH Capital on its bids for ASX-listed companies, Healthscope and Navitas.

Similar large take-private transactions have featured prominently in recent times, with other notable examples being EQT Infrastructure's recently aborted bid for Vocus Group, KKR's acquisition of MYOB and TPG's takeover of Greencross. According to the AIC, the volume of PE-backed bids for ASX-listed companies is the highest since 2006.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Factors encouraging investment include low interest rates and the low Australian dollar. This is coupled with recent data published by Cambridge Associates showing the Australian PE industry performing as well as their North American and European counterparts (and slightly ahead of developed Asia) over a 20-year sample, having delivered an annualised return of 13% over that period.

Factors inhibiting investment include intense competition for value investments, with high-profile figures from the Future Fund and Bain & Company recently commenting that the Australian PE industry may be peaking.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

PE is expected to be a significant contributor to Australian M&A transactions in 2019. This is notwithstanding the fact that the local market is under-represented in terms of PE activity, which typically accounts for about 15% of M&A activity (compared to 30% in more established markets).

Given the high levels of dry powder amongst PE funds and intense competition for value investments in private companies, we anticipate public-to-private bids becoming more prevalent. PE managers are expected to seek out bilateral transactions for assets, rather than competing with their contemporaries in auction processes in order to provide alternative forms of investment in attractive businesses through private credit or special situation funds.

Until IPO markets open up again, we anticipate that the low proportion of IPO exits (comprising just 6% of all PE exits in 2018) will continue.

Warranty & indemnity (**W&I**) insurance policies are commonplace in Australia but are tending toward more extensive exclusions (see question 6.4 below), thereby limiting coverage and driving counterparties to look for other forms of contractual protection for those excluded matters.

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2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

The acquisition structure for a leverage deal most commonly involves a three-level "stack" of Australian-incorporated private holding companies, with PE investors and management taking equity in the top entity in the structure (the "HoldCo" or "TopCo"), bank debt coming in at the second level ("FinCo") and the acquisition being made by the FinCo's subsidiary ("BidCo").

2.2 What are the main drivers for these acquisition structures?

One of the drivers for the selected acquisition structure is tax efficiency. This is both from the perspective of the PE fund and the group companies: the deductibility of interest on debt repayments should be available to the group companies subject to integrity regimes, and meeting equity incentive criteria should be achieved for the management team.

The three-tiered "stack" structure also provides structural subordination for the financiers of the group, with funding coming in at FinCo level, being the middle entity of the stack positioned below the equity interests of the PE fund and management team at HoldCo level.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

Both institutional investors and management most commonly subscribe for ordinary equity, with institutional shareholders holding ordinary shares (and potentially shareholder loans) and management subscribing for a separate class of ordinary equity, which generally has: (i) restrictions on voting rights; (ii) compulsory acquisition requirements and transfer restrictions; and (iii) may involve a ratchet on exit.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

If a PE investor is taking a minority position, there may not be material differences in respect of structuring, save that a minority PE investor: (i) may want to protect their downside risk by seeking preference rights on a liquidation, including subscribing for convertible preference shares; and (ii) will want to carefully structure the governance arrangements in order to impose voting, veto and control rights in respect of certain matters.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Management is typically allocated between 5–15% of the equity in a holding vehicle, with vesting depending on the structuring of management's equity, whether the subscription proceeds have been funded by a non-recourse loan and the expected time to exit.

Compulsory acquisition provisions are often triggered by matters such as material breach of the shareholders' agreement (including transfer or assignment of shares in breach of the agreement), becoming a "bad leaver" or insolvency. The Australian *Corporations Act 2001* (Cth) (the **Corporations Act**) regulates a company's acquisition of its own shares from a shareholder.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Leaver provisions are generally more bespoke in Australia than in the US where fairly constant formulations of good and bad leaver are typical.

In Australia, a good leaver is generally a manager who "leaves" their employment because of death, permanent disability or incapacity or redundancy or is otherwise deemed a good leaver at the discretion of the board. A good leaver would typically have their shares compulsorily acquired for fair market value (or the higher of cost and fair market value in certain circumstances).

A bad leaver is generally a manager who "leaves" their employment but is not otherwise a good leaver. Bad leavers would typically have their shares compulsorily acquired for the lower of cost and fair market value (sometimes with an additional discount to account for costs of the compulsory acquisition (e.g. the acquisition price may be 90% of the lower of cost or fair market value)). Unlike the UK, the concept of intermediate leaver is rarely, if ever, seen.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

PE portfolio companies are customarily private companies governed by the constitution of the relevant company (which ordinarily deals with fairly generic corporate issues) and the shareholders' agreement entered into between the PE investor, the managers, other share or right holders, and the target company (which deals with more bespoke governance and operational issues).

Neither the shareholders' agreement nor the constitution of private companies is required to be made public.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Nominee directors of controlling PE investors (rather than the investor themselves) generally have the benefit of veto rights over major transactions and other material operational matters under a shareholders' agreement.

Minority investors normally have their veto rights restricted to key constitutional issues and highly material transactions, rather than mere operational matters.

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3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

Certain corporate actions (e.g. adopting a constitution, changing a company's name and varying or cancelling class rights) may only be effected under the Corporations Act by a special resolution of shareholders (being 75% of the votes cast on the resolution), meaning that a shareholder veto in respect of such matters by shareholders holding less than 25% of the voting shares would be ineffective under the Corporations Act, but may still be effective under a shareholders' agreement.

Although a shareholders' agreement and company constitution may include an acknowledgment that the nominee director is entitled to act in the best interests of their appointor (being the PE investor) and nominee directors may have the benefit of contractual veto rights under a shareholders' agreement, the directors will still be subject to their general fiduciary and statutory duties when exercising such rights. These include duties to act with care and diligence, in good faith, for a proper purpose, not to misuse their position, to prevent insolvent trading, to avoid conflicts, and to not fetter their discretion.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or vice versa)? If so, how are these typically addressed?

There are no specific duties owed by a PE investor to minority shareholders or management shareholders (or *vice versa*). However, the minority shareholders may have the benefit of: (i) certain contractual protections in the constitution and/or a shareholders' agreement; and (ii) general statutory and common law minority shareholder protections such as the prohibition on oppression of the minority.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Generally, there are no limitations or restrictions on the contents or enforceability of shareholder agreements other than: (i) general prohibitions on the enforcement of terms which are, for example, contrary to public policy or which oppress the minority; and (ii) any restraint needs to protect a legitimate business interest and be reasonable (including the restraint period and the geographical restriction, which are often cascaded to assist with enforceability).

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

Nominee directors should always be generally aware of their directors' duties (see question 3.3 above). They can be subject to personal liability in certain circumstances under Australian law (for example, for insolvent trading, environmental laws, work health and safety laws, complicity in tax-related offences, or for being an accessory to underpayment of employee entitlements).

PE investors should ensure that both directors' and officers' insurance policies are in place and that deeds of indemnity, insurance and access are entered into for the benefit of their nominee directors. There are certain statutory restrictions on indemnifying a director (e.g. for fraudulent acts, certain penalties and costs or liabilities to the company itself).

PE investors will generally have the benefit of the corporate veil to protect them from incurring liability on behalf of their investee companies (subject to certain exceptions such as fraud). PE investors should also be mindful of avoiding shadow director liability, which can accrue if the company becomes accustomed to acting in accordance with the investors' instructions or wishes rather than those of the nominee directors. This may arise if, to avoid issues of director duty liability, matters are routinely referred to shareholders to vote on.

In addition, Australian private companies need to have at least one Australian-resident director at all times.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

As noted above, the constitution of a company or a shareholders' agreement may permit a nominee director to act in the interests of a PE investor as their appointor. However, this will not absolve the director of their general law and statutory directors' duties (most relevantly, to avoid conflicts).

Where a director has a conflict of interest in relation to a particular matter, the issue may be resolved by referring it to a shareholder vote. However, the shareholder will need to be cognisant of not incurring shadow director liability (see question 3.6 above).

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

Foreign Investment Review Board (FIRB)

As mentioned in question 10.2 below, foreign PE investors (and even local PE investors which have "foreign government investors" (**FGIs**) as limited partners) often need to seek foreign investment approval for their acquisitions. Accordingly, it would be prudent for PE investors to obtain FIRB advice on transactions as soon as practicable. The FIRB must make a decision on an application within 30 days after it receives the application fee for that application. If FIRB cannot make a decision within this timeframe, it can make an interim order extending the period for up to 90 further days (having the effect of making the decision process public) or may alternatively request that the investor consents to a voluntary time extension (meaning that the decision process can be kept confidential).

Competition

There is no mandatory requirement to seek antitrust approval in Australia (called informal clearance). The antitrust approval (or informal clearance) process is voluntary and, if a party wishes to

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obtain informal clearance from the Australian Competition and Consumer Commission (**ACCC**), the timing of that clearance will vary depending on the nature and extent of competition issues arising from a transaction. As there are significant penalties for breaches of the merger competition law regime, parties often seek informal clearance for a transaction prior to completion where the transaction may give rise to competition (or anti-trust) concerns.

Where parties apply to the ACCC for informal clearance and the ACCC considers that the transaction is unlikely to substantially lessen competition in any market, the ACCC will generally "clear" the transaction within two to four weeks without conducting market enquiries.

If, however, the ACCC considers that the transaction may give rise to competition concerns, the ACCC will undertake market enquiries to test the nature and extent of those concerns. While the duration of market enquiries will depend on a number of factors including the complexity of the competition concerns and whether the parties provide further information to the ACCC, the ACCC seeks to make a decision within six to 12 weeks of commencing the market enquiries process.

Financing – financial assistance

Because the granting of security by target group members constitutes the giving of financial assistance to acquire shares of their holding company under the Corporations Act, the target companies (and the ultimate Australian holding company's shareholders) will generally need to approve the giving of such financial assistance. The corporate regulator, the Australian Investments and Securities Commission, needs to be notified at least 14 days before the financial assistance is given, meaning that, unless the sellers agree to be involved in the process, the PE investor and its financier will not be able to put in place security until at least 14 days post-completion of the acquisition. The financier will generally try to protect themselves from residual risk in this period with various undertakings from the target group until the security package is in place (see also question 8.2 below).

Change of control consents

Consents to changes in control from material contract counterparties and landlords are regularly required and obtaining the consent of such counterparties can be a time-consuming exercise. Unlike the US or the UK, most Australian leases contain a change of control restriction. Often, a PE investor will take a pragmatic approach and choose to complete even in the absence of such consent and seek the consent of such third parties post-completion.

4.2 Have there been any discernible trends in transaction terms over recent years?

Given that the Australian market is more fragmented than the US or UK markets, market terms are not as standard and, coupled with the lower volume of deals, discernible trends are less readily identified.

Recently, however, the prevalence of W&I insurance has changed the exit regime, with retentions and escrows being much less common.

Another trend in technology transactions is buyers insisting that warranties relating to intellectual property are treated as fundamental warranties (thereby availing themselves of the more favourable limitation regime (see question 6.5 below)).

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

The Australian Takeovers Panel requires that a bidder has funding in place (or a reasonable basis to expect that it will have funding in place) to pay for all acceptances when a takeover bid becomes unconditional. A consequence of this is that in a hostile bid context, financing may be difficult to obtain in the absence of detailed due diligence (since a hostile bidder will not be granted a right to complete due diligence).

Further, to avoid potential actual or perceived conflicts of interest relating to "insiders", the Australian Takeovers Panel's Guidance Note on Insider Participation in Control Transactions requires that protocols (which are to be supervised by the independent directors) be put in place in respect of any "participating insiders" such as senior management or participating directors who will benefit from a takeover bid by a PE investor.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

PE investors may seek exclusivity protection in a public acquisition in various forms of lock-up devices such as "no shop", "no talk", "no due diligence" or "no matching rights" obligations. Break fees (not exceeding 1% of the equity value of the target) are often payable if the target walks away from discussions or chooses an alternative offer. Importantly, such protections are regularly subject to a "fiduciary out" for the directors of the target, which is a provision that allows the directors to be relieved of a lock-up obligation (or aspects of it) if their directors duties require them to do so.

A relatively new development is the use of W&I insurance for public acquisitions which are based on sole recourse to the policy and the target (rather than the seller) giving the warranties.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

On the sell-side, PE investors prefer all cash consideration, payable on completion (i.e. no deferred consideration, no escrow or other retention and no completion accounts adjustment). This provides the seller with certainty of proceeds and allows the investor to quickly distribute funds to its Limited Partners.

Conversely, on the buy-side, PE investors prefer deferring consideration so as to delay payment and the increase internal rate of return (**IRR**). Examples of this may include earn outs, escrows or standard deferred consideration (essentially vendor financing).

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

In Australia, unlike in the UK, PE investors are typically expected to provide the same package of warranties and indemnities to a buyer

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as those provided by the management team. As previously mentioned, exiting PE investors will typically require that a buy-side W&I insurance policy is put in place in respect of the warranties and the tax indemnity. PE sellers will often resist providing any warranties which are excluded, or only partially covered, under the relevant policy.

Similar to the US, warranties are generally given by the warrantors on an indemnity basis (unlike the UK).

In the absence of W&I insurance, a PE investor on the buy-side may take a different view as to the warranties provided by the management team depending on whether they are continuing in the business and taking material management positions, on the basis that investors will be hesitant to sue their investee company's management team for a breach of warranty.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Other covenants, undertakings and indemnities provided to the buyer include those relating to conduct between signing and completion (including assistance with obtaining change of control consents), leakage covenants and indemnities (in locked box deals), access to premises, records and employees prior to completion, specific indemnities in respect of known risks or risks which are otherwise excluded under the W&I policy and management restraints (with PE sellers normally averse to agreeing to a restraint).

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Buy-side W&I insurance is commonplace in PE transactions in Australia.

Typical excesses (or retentions) are approximately 1% of the enterprise value. Policy limits are tailored to each transaction and typically range from 20–70% of the enterprise value (matches the range of maximum liability that warrantors would normally accept in relation to non-fundamental warranties).

Typical exclusions include warranties relating to known risks, bribery, pension underfunding, forecasts and forward-looking statements, product or service liability, environmental warranties, cyber events, issues relating to the classification of contractors as employees, fraud and other matters already known to the buyer.

W&I insurance in Australia typically costs between 1–1.5% of the policy limit (including brokerage). GST and stamp duty also apply. Capped underwriting fees apply initially, but are waived on policy inception.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

The limitation regime is generally bifurcated between:

(i) tax and fundamental warranties. These may not be subject to a *de minimis* or bucket (in the case of fundamental warranties), may not be disclosed against and generally have a time limit of approximately five years for uninsured deals or seven years for insured deals. An aggregate cap of the equity value will also generally apply; and

(ii) general business warranties (i.e. all warranties other than tax and fundamental warranties). These will typically have a *de minimis* of 0.1% of enterprise value, a bucket of 1% of enterprise value (which is normally a tipping bucket in non-insured deals and may be applied in insured deals for an additional fee), may be disclosed against, and have a time limit of at least one audit cycle for uninsured deals or three years for insured deals. The aggregate cap on liability will depend on the deal; however, a range of 20–70% of the enterprise value could apply.

A PE seller will generally try and limit its aggregate liability for all claims (including undertakings and warranties) to the equity value.

Limitations on liability in insured deals will generally match the limitation regime provided for in the W&I insurance policy.

In Australia, general disclosure of the data room against the warranties is standard. This means that, unlike in the UK where general disclosure of the data room is accepted but disclosure letters are still commonplace, disclosure letters are much less common than in the UK and the US. Even when used, disclosure letters require much less specific disclosure than in the US.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

As mentioned in question 6.1 above, PE sellers strongly resist providing any security for liabilities as this would impede distributing proceeds to their Limited Partners immediately post sale. However, given the prevalence of W&I insurance, the risk is transferred to the insurer meaning escrow for warranties/liabilities is now often irrelevant.

In the absence of W&I insurance on the buy-side, PE buyers often seek an escrow or retention amount as security for warranty and/or liability claims. Escrows are more often sought from management team vendors because they are often counterparties of less financial means than institutional vendors.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Comfort as to the availability of debt finance is normally provided in the form of a debt commitment letter and terms sheet issued by the lead financier. Comfort as to the availability of equity finance is normally provided in the form of an equity commitment letter issued by the PE buyer. Sellers may have rights to contractual damages or to specific performance in the absence of compliance with such documents.

Less common is a non-refundable deposit which may be provided by the buyer and provides some comfort and some compensation in the event of the buyer's failure to complete a transaction.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are not prevalent in Australian PE transactions.

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7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

Lock-ups and escrow obligations (see question 7.2 below) imposed on sellers in an IPO means that an IPO does not provide an immediate and complete exit. An IPO process is also more involved and could take longer to implement than a trade sale.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

PE sellers are often subject to underwriter-imposed (i.e. the sellers agree to a voluntary lock-up to assist with marketing the IPO) lock-up obligations for a period of 12–24 months, often coinciding with the end of a forecast period (subject to certain exceptions if the share price outperforms the offer price).

Mandatory lock-up obligations may also be imposed on PE sellers if the listed entity is admitted through the "assets test". This would often be for a 12–24-month period depending on the circumstances.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Dual-track exit processes are often cited to try and drive competitive tension, but are practically less common than singularly pursuing a trade sale exit.

The AIC has reported a continuing decline in the number of IPOs and private placements as a proportion of total buyout exits, with IPOs representing 53% of all exits in 2015, 30% in 2016, 20% in 2017 and 6% in 2018 and trade sales as a proportion of all exits increasing from 32% in 2015, to 58% in 2016, to 63% in 2017 and 73% in 2018.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

The predominant source of debt funding remains syndicated secured term loan facilities, rather than bonds and securitisation structures. Consistent with recent years, there has been a continued retreat by the Australian commercial banks from the Australian leveraged finance market, with the funding gap increasingly being filled by Australian credit funds, and offshore commercial and investment banks.

In keeping with the recent years, typical tenures are of three to five years for leveraged finance facilities, with senior debt for new transactions generally not exceeding 50% to 70% of enterprise value (depending upon sponsor and sector) but with capacity for uncommitted "accordion facilities" allowing for the top-up of senior debt for permitted acquisitions and growth capital expenditure.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

There are few financing restrictions idiosyncratic to Australian leveraged finance transactions, with security being able to be granted by Australian companies to acquisition financiers (generally through a security trust mechanism). Two of the primary structuring considerations on leveraged finance transactions continue to be: (i) Australian interest withholding tax (**AIWT**) will generally apply (and be payable as a liability of the borrower through a gross-up mechanism) in relation to interest paid to non-Australian lenders who either (1) do not have an Australian lending office, or (2) are not able to rely on 100% relief under a relevant Double Taxation Treaty. An alternative statutory process for syndicated transactions to address liability for AIWT is to comply with the requirements of section 128F of the *Income Tax Assessment Act 1936* (Cth); and (ii) compliance with the statutory processes to address the Australian financial assistance prohibition under the Corporations Act (see question 4.1 above). There is a settled Australian statutory shareholder "whitewash" process which addresses the financial assistance prohibition, so it should not generally be considered an impediment to transaction execution.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

Unitranche and US Term B transactions (with and without subordinated mezzanine/second lien tranches) continue to be utilised by global sponsors for larger Australian buyouts. Active lenders include Barings, HPS, Partners Group, Macquarie Bank, Credit Suisse and Nomura. Lenders active as super-senior working capital tranche lenders include Investec, HSBC and National Australia Bank.

In relation to the domestic market (and as noted in question 8.1), the retreat of Australian commercial banks from leveraged finance credits has provided an opportunity for both Australian and offshore credit funds to provide typical syndicated (or bilateral) acquisition loans (often on a stretched basis). Active Australian credit funds include Challenger, IFM and Metrics Credit Partners. Superannuation funds such as AustralianSuper have also been participants in senior syndicated leveraged credits. Active offshore and investment banks include Bain Capital Credit, Nomura, MUFG, ING, SMBC, HSBC, Natixis and BNP Paribas.

In addition, unitranche lenders have squarely targeted the mid- to upper mid-market for good domestic sponsors and have become viable and attractive acquisition finance sources, particularly given their initial gearing of up to 5.5 times (not at a level that global sponsors will attain, but still substantially better than Australian bank lenders will be able to approve), 6+-year tenors, minimal (if any) amortisation, (generally) covenant-lite structure and pricing now in the mid 500bps. Customary call protection will likely apply but in context this is not generally seen as problematic.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Offshore PE funds will often establish a special purpose vehicle

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(**SPV**) (or a chain of SPVs) under Australian law which it will wholly own. The type of structure established for the SPV will depend on the nature of the asset being acquired. This will typically be a private company to hold business assets or a unit trust to hold real property or infrastructure assets.

The benefits of the SPV being a company from an Australian tax perspective include the use of the Australian tax consolidation (or single taxpayer) regime. This will enable the purchase price for the acquired shares in the target to be "pushed down" to the underlying business assets to, in most cases, resetting their tax costs (possibly leading to an uplift in tax costs for depreciation, etc).

Where the SPV acquires a capital asset such as real property or infrastructure assets, a unit trust could be established and if it qualifies as "managed investment trust" (or **MIT**), concessional withholding tax rates of 15% may apply. This requires among other things, that the non-resident is resident in a jurisdiction with an informal exchange treaty with Australia and the MIT itself satisfies the relevant legislation requirements.

Some other considerations will be whether:

- the interest the offshore PE fund holds will be classified as either a debt or equity interest under Australia's debt/equity rules as this may result in a different tax treatment on returns made on investments;
- the Australian asset acquired by the PE fund is treated as being held on revenue or capital account;
- any cross-border dealings with related parties comply with Australia's transfer pricing and thin capitalisation regimes. These regimes seek to combat non-arm's-length dealings or interest deductions on excessive debt funding, in both cases ensuring that profits do not escape Australian taxation as a result; and
- any of the integrity regimes that have been legislated as part of Australia's response to the OECD Base Erosion Profit Shifting Action Items (BEPS Project) apply including the:
  - multinational anti-avoidance law;
  - anti-hybrid rules;
  - diverted profits tax; and
  - country by country reporting.

Offshore structures are common in the Australian PE landscape. They usually take the form of a limited partnership where the general partner is established in the Cayman Islands or British Virgin Islands and the investors are the Limited Partners either established in the same jurisdictions as the general partners or in other jurisdictions. They can also take the form of limited liability companies (**LLC**) incorporated in Delaware in the US. Such LLCs are usually tax-transparent entities in the jurisdiction of their domicile.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Where the management teams of the Australian target entity are partly remunerated with shares or options to shares in the acquisition vehicle, they will be subject to tax in accordance with the Australian employee share scheme provisions. Under these provisions, the discount on the shares or option received will be taxed as income on either an upfront basis or on a deferred basis if the requirements for deferral are met.

Loan-funded share schemes are also common and involve loans being made to the management team to purchase the relevant shares for their market value. The loans are often secured on a limited recourse basis and repayable on an exit event.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

The key considerations for the management team who are Australian tax residents holding their investment on capital account where there is an exit event are as follows:

- whether they can apply the 50% CGT discount when calculating their taxable capital gains on disposal of their shares. This will require, among other things, that they hold their investment for a period of not less than 12 months and in an eligible vehicle; and
- whether they can access the scrip-for-scrip rollover relief if they receive shares in a new acquisition structure. This requires, among other things, that the acquirer becomes the holder of at least 80% of the voting shares in the target company.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

Some recent changes include:

- from 1 July 2018, Australia's thin capitalisation rules have been amended to deny foreign investors from using doubled geared structures to convert active business income to interest income, the latter attracting lower withholding tax rates;
- from 1 October 2018, new anti-hybrid rules have been legislated as Australia's response to Action Item 2 of the BEPS Project;
- from 1 July 2019, a minimum 30% withholding tax on trading income converted to passive income distributed by an MIT and as part of a stapled structure; and
- from 1 July 2019, existing tax exemptions for foreign pension funds and sovereign wealth funds will be limited to passive income and portfolio investments (typically interests of less than 10%).

Consultations continue in respect of legislation establishing new collective investment vehicles being the corporate investment vehicle or CCIV and a limited partnership, both intended to be recognisable to foreign investors.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

FIRB commonly imposes conditions on its approval in relation to compliance with taxation laws and data security.

A number of substantive changes to Australian competition laws came into effect toward the end of 2017 that may have an impact on certain PE investors.

See question 9.4 above for details of developments from a tax perspective.

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10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

PE investors (whether based locally or offshore) are often subject to enhanced regulatory scrutiny in Australia in the form of Australia's foreign investment regime. Non-Australian entities proposing to acquire an interest in, or control of, an Australian business that is valued above $266 million (or $1.154 billion for acquisitions by certain investors from the US and certain other countries) must seek the approval of FIRB. However, except in limited circumstances, a FIRB approval is required regardless of the value of the acquisition, where the acquiring entity is considered a "foreign government investor" (**FGI**).

Many foreign and even Australian PE investors meet this test due to the nature of their limited partner base. Examples of ownership that may result in classification of an investment target as an FGI include: sovereign wealth funds; banks; insurance companies and other financial institutions with state ownership in excess of 20%; and even more commonly, pension funds for state employees, public university endowment funds, etc. See question 4.1 above for the timetable implications for FIRB applications.

Particular transactions attracting enhanced scrutiny include those involving businesses which transfer personal data and transactions in the media sector or agribusiness sector involving the sale of Australian agricultural assets.

PE investors are not subject to enhanced scrutiny by the ACCC but where a transaction requires approval from FIRB, the ACCC will be asked to provide its view on whether the transaction raises any competition concerns. Accordingly, transactions notified to FIRB will be notified to the ACCC regardless of whether the parties have a desire to notify the ACCC.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

Sophisticated PE investors in Australia typically conduct very detailed due diligence in respect of acquisitions, with the approach to such diligence, the materiality thresholds and the form of any such reporting dependent on the circumstances of the acquisition. Financiers and W&I insurers (where W&I insurance is sought) typically require the comfort of a bespoke and detailed diligence process, typically (but not always) from external advisors.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

There is an increasing focus on anti-bribery or anti-corruption compliance in Australian PE transactions, particularly in transactions involving international investors (particularly North American counterparties) or, as you would expect, in respect of acquisitions of Australian businesses which conduct business in sanctioned jurisdictions or which have relationships with sanctioned or politically exposed persons. The difficulty with bribery or corruption is that they are inherently difficult to conduct due diligence on and, as a result, are typically excluded from W&I insurance coverage. As a consequence, an investor may need to seek other contractual protections in the form of specific indemnities.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

The circumstances in which a PE investor may be held liable for the liabilities of the underlying portfolio companies are limited to circumstances in which the corporate veil can be pierced. That is, through fraud or in limited circumstances through the operation of particular legislation such as acting as a shadow director or under section 545 of the *Fair Work Act 2009* (Cth), which empowers a court to make orders that an accessory (which can include shareholders, and not just an employer), to be liable to back-pay employee entitlements.

It is difficult to envisage any circumstances in which one portfolio company may be held liable for the liabilities of another portfolio company.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

There are limited additional concerns for PE investors in Australia not already referred to above. As noted above, the PE industry is healthy in Australia, highlighted by the record-breaking fundraising in recent times.

This chapter was prepared on the basis of laws and policies in effect as at 13 June 2019.

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Austria

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

Austria has seen the full spectrum of private equity transactions.

In the large-cap (buyout) segment (deal values of EUR 100 million and above) the main trend over the last two to three years was the increased use of vendor due diligence and warranty and indemnity insurance as well as the increased interest of debt funds to finance the term loan facilities in leveraged buyout transactions ("LBO"). In terms of sectors, there was no discernible trend. This is mainly due to the limited number of transactions within that segment. In the midmarket (buyout) segment (comprising deals with values between EUR 10 million and EUR 100 million, which make up the vast majority of Austrian deals) tax-optimised roll-over structures were increasingly used allowing founders or other sellers to reinvest part of the proceeds. In terms of sectors, technology, healthcare, industrials and business services accounted for most of the deal flow in this segment. Another trend that continued from 2017 is increased activity in the growth capital segment with corporate seed capital and corporate venture capital funds becoming increasingly active and causing significant competition for traditional venture and growth capital funds. Investors from Asia (in particular, China) also increasingly played roles.

On the debt side, specialist debt funds have become increasingly active over the last two years, not only in the large-cap (buyout) segment. These days debt funds offer all sorts of instruments, ranging from growth capital, stressed financing, acquisition financing to bridge and DIP loans.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Please see question 1.1.

Austrian companies often have substantial CEE exposure which is perceived as an opportunity by some private equity funds, but it is an issue for other funds who must not invest in targets in the CEE, or with considerable CEE exposure, pursuant to their LPA investment mandate.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

We expect to see an increased deal flow in the venture capital and growth capital segment and a continuing robust deal flow in the midmarket segment over the next 12 months. We also expect to see more distressed transactions over the next 24 months again. Generally, the sentiment appears to be that this asset class will see significant deal flow and show good returns. This is also reflected by more recent LP allocations.

In terms of operation of the market, we expect the DACH markets (including the Austrian market) to more and more converge with the German market.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

The typical onshore acquisition structure involves one or more holding companies ("HoldCos") and an acquisition vehicle ("BidCo"), which then enters into the purchase agreement and ultimately acquires the shares. From a tax perspective, this multi-layer holding structure is no longer necessary (see question 2.2). In leveraged transactions, interim holding companies are, however, often still needed as senior lenders typically insist that junior lenders lend a level higher in the structure to achieve not only contractual subordination (which is achieved through an inter-creditor or subordination agreement), but also structural subordination of junior debt.

Private equity funds will usually try to maximise debt in the financing structure for a transaction. The difference between available bank debt and the purchase price is financed by the fund through a combination of debt (so-called, "institutional debt") and equity. How much institutional debt can be employed is determined by "thin cap" rules. While there are no statutory rules in place, debt-to-equity ratios of 3:1 to 4:1 are generally accepted by the Austrian tax authorities.

Where bank debt is employed, the target company is usually required to accede to the financing documents on an exclusive lender basis (to avoid structural subordination to existing lenders) and to grant guarantees and security interests securing acquisition debt as well as the refinanced target company debt on or shortly

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after completion. To the extent guarantees and security interests secure acquisition debt, capital maintenance and, where a joint stock company ("JSC") is involved, financial assistance rules are a concern. Transactions violating capital maintenance rules are null and void as between the parties as well as any third party (e.g. the financing bank) if that third party knew, or should have known, of the violation. In addition, the members of the management and supervisory board who approved the transaction may be subject to liability for damages. Transactions violating financial assistance rules, on the other hand, are not void but may result in liability of the members of the management and supervisory board who approved the transaction. Both issues are usually addressed in the financing documents by "limitation language" which limits the obligations of Austrian obligors to an amount and terms compliant with capital maintenance and financial assistance rules.

2.2 What are the main drivers for these acquisition structures?

The main drivers for the acquisition structures described under question 2.1 are tax and subordination.

With regard to taxes, the main argument for Austrian multilayer HoldCo and BidCo structures was the availability of goodwill amortisation on share deals and that capital tax on capital contributions could be avoided in case of indirect parent contributions; neither are relevant now. Austrian HoldCos and BidCos can, however, still enter into a tax group with the target company. This allows for a set-off of interest expenses at HoldCo and BidCo level with the taxable profits of the target company (for a more detailed discussion, please see question 9.1).

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

Institutional equity is usually given offshore and passed onto the Austrian HoldCo and BidCo structure by way of one or more (direct or indirect) capital contributions or shareholder loans.

Management equity is often given in the form of actual shares, either in the target company itself (or the entity in which the exit is expected to occur) or shares in entities further above. From a tax perspective, actual shares (and certain other equity interests) may have benefits relative to phantom stock and other contractual bonus scheme arrangements, as gains realised upon an exit may be eligible for capital gains taxation as opposed to employment income.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Private equity investors taking a minority position typically insist on new governance documents (for a description, see question 3.1). Where that request is rejected, the investor must carefully analyse what rights are available to him following completion under the existing governance documents and, where necessary, request amendments. In that process, it is important to become familiar with the minority protections already available under the law, which of them are mandatory, which of them can be amended to the benefit of minority shareholders only, and which of them can be amended without restriction. Which protections are available differs but, generally, protection includes information rights, rights to call a shareholders' meeting, quorum, and voting requirements for major corporate actions (such as corporate restructurings, a change of the company's purpose, changes to the articles of association, dealings involving all or substantially all of the business or assets, and squeeze-outs of shareholders).

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Management equity is typically subject to vesting over a period of three to five years. Compulsory transfer provisions apply upon termination of the manager, with consideration varying depending on the reason for termination (a "good" or a "bad" leaver), although structures have become less aggressive in that regard due to recent developments in Austrian labour law. In addition, the private equity fund will require a right to drag-along the management upon an exit and often insist on pooling of the management equity in a pooling vehicle (often a partnership).

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

In their simplest form, good and bad leaver provisions make reference to employment law and treat a manager as a bad leaver if he is dismissed (*entlassen*) by the company for good cause or if he terminates his employment (*kündigen*) on his own initiative without cause (*ohne wichtigen Grund*). More sophisticated provisions specifically define good leavers and bad leavers (e.g. in case of fraud, dishonesty, material breach, underperformance). Attaining retirement age, death or permanent incapacity or disability are usually good leaver cases.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

The governance documents typically include:

- a shareholders' agreement;
- new articles of association; and
- by-laws for the management board and supervisory board (if any).

The main areas of concern in the governance documents are the private equity fund's rights to appoint sponsor representatives (and/or observers) to the supervisory board (if any) or advisory board (if any), sponsor representative liability and conflicts of interest, veto rights of the fund (and/or the sponsor representative) (see question 3.2), dilution protection for the fund, a liquidation preference for the fund, restrictions on dealings with shares (typically including a lock-up, rights of first refusal, tag-along, and drag-along rights), exit rights for the fund (via a trade sale, an IPO or a shotgun mechanism) as well as reporting, information and access rights.

In the majority of cases, the fund will also insist that senior management signs up to an incentive scheme (see question 2.3) and that all of the management team (and sometimes also certain other key personnel) enters into new employment agreements on terms agreed with the fund.

To the extent the above arrangements are included in the articles of association (which has some benefits for some (but not all) of them

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from an enforcement perspective (see question 3.3)), they are publicly accessible through the companies register. In addition, certain arrangements may have to be disclosed under Securities Law disclosure requirements.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

The governance documents will typically include veto rights of the private equity fund (and/or a sponsor representative on a supervisory board) over major corporate actions and strategic decisions (such as acquisitions and disposals, major litigation, indebtedness, changing the nature of the business, business plans and strategy) although the specific requirements vary widely from fund to fund and deal to deal. Usually, such veto rights are structured to fall away if the relevant fund's interest is reduced below a certain quota. Where multiple private equity funds invest, they will generally insist that all investors agree and vote on some set of veto matters, with quorum and majority voting requirements varying widely from deal to deal.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

If a veto (or majority) requirement is included in the articles of association (and/or by-laws), resolutions violating the arrangement can be challenged. In contrast, if a veto right (or majority requirement) set forth in the shareholders' agreement is violated, only actions for damages and cease and desist orders are available. It should be noted, however, that in one decision the Austrian Supreme Court also accepted a challenge of a shareholders' resolution in breach of a majority requirement set forth in a shareholders' agreement. In that case, all shareholders were a party to the agreement. This will usually be the case in private equity transactions where the shareholders' agreement typically provides for a mandatory accession clause. Regarding management board member actions, it must be noted that, towards third parties, the power of representation cannot be limited in the shareholders' agreement, the articles of association, the by-laws or elsewhere in such a way that the company is not bound if a member transacts in violation of a contractually agreed veto (or majority) requirement.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

Austrian courts have consistently held that shareholders owe a duty of loyalty (*Treuepflicht*) towards one another, requiring them to consider the interests of their fellow shareholders in good faith (*Treu und Glauben*) and in line with *bonos mores* (*gute Sitten*). That duty is more pronounced for closely held companies than for widely held companies and differs from shareholder to shareholder, depending on their ability to cause a certain action to be taken or not to be taken. A majority shareholder may therefore be exposed to liability in circumstances where a minority shareholder is not (because his appearance or vote would not have mattered in the circumstances anyway). A violation of the duty of loyalty may result in claims for damages, cease and desist orders, or a challenge (*Anfechtung*) of shareholder resolutions.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Shareholders' agreements are typically governed by Austrian law and the competent courts at the seat of the company typically have jurisdiction. This is mainly because disputes related to shareholders' agreements are usually supported by arguments based on Austrian corporate law and corporate law disputes must be brought before the courts at the seat of the company. However, where Austrian court judgments are not enforceable in the jurisdiction of a particular shareholder, arbitration is sometimes agreed as an option.

Non-compete and non-solicitation provisions are generally enforceable for the period of the shareholding (for that period, contractual restrictions compete with the corporate law-based duty of loyalty (see question 3.4)) and for up to two (in exceptional cases, three) years thereafter. Where a shareholder was also an employee (which could be the case for management shareholders), the restriction will also be scrutinised under employment law and is generally only valid for a period of up to one year and to the extent that the restriction does not unduly limit the employee's future prospects. If backed up by a contractual penalty only its payment can be requested (but not compliance).

It should be noted that where a shareholders' agreement includes an obligation to transfer shares of a limited liability company (such as an option or a drag-along right), it must be drawn up in the form of an Austrian notarial deed if the obligation to transfer is to be enforceable (note: a German notarial deed is considered equivalent).

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

General

Austria has a two-tier board structure. The management board is responsible for the day-to-day management of the company, while the supervisory board is responsible for monitoring and resolving on the matters brought before the supervisory board for a vote (which is a matter for the governing documents). Sponsors usually request rights to nominate one (or more) members of the supervisory board (*Aufsichtsrat*) or observers to the supervisory board, but hardly ever get involved in management. For that reason, the answers under questions 3.6 and 3.7 will focus on supervisory board nominees.

Restrictions

Restrictions with respect to the aggregate number of supervisory board positions and provisions aimed at preventing conflicts of interest exist: Supervisory board members must not be managing directors of the portfolio company or of a subsidiary, or employees of the portfolio company (employee representatives are exempt from that restriction). They must not hold more than 10 (eight for a listed JSC) supervisory board positions (with chairman positions counting double and exceptions for group positions), or be appointed a managing director of a subsidiary or of another company to whose supervisory board a member of the management

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board of the portfolio company is appointed (unless that company belongs to a group (*Konzern*)).

Requirements

Corporate law does not require a specific qualification or experience for supervisory board members. Such requirements can be introduced in the articles of association. However, every supervisory board member must be able to meet its duty of care (*Sorgfalspflicht*) requiring the relevant member to exercise the level of care of a proper and diligent supervisory board member of the particular company (that is, a supervisory board member of a biotech company will have to have different knowledge and skills from a supervisory board member of a company that is in the retail business). In general terms, a supervisory board member must have at least a basic understanding of the business brought before the supervisory board, understand financial statements and be able to assess when an expert opinion is required and to devote sufficient time.

Risks and liability

Members of the supervisory board owe to the portfolio company (and not to the private equity investor appointing them or to any other constituents): a duty of care (*Sorgfaltspflicht*) (see above – which includes an obligation to be reasonably informed and to articulate any concerns he may have); a duty of loyalty (*Treuepflicht*) (requiring the member to act in the best interest of the company and its shareholders and not in his own interest); and a duty of confidentiality. A supervisory board member is not prohibited to compete with the business of the portfolio company, as long as there is no breach of the duty of loyalty. Absent a breach of their corporate duty of care, supervisory board members can generally not be held liable for a portfolio company's breach of administrative law or criminal law. A supervisory board member may, however, become liable for his own conduct, including, without limitation: for fraud (*Betrug*) (e.g. by entering or approving a transaction intended to mislead another); for breach of trust (*Untreue*) (e.g. by entering or approving a transaction that is adverse to the interests of shareholders); for misrepresentation (e.g. with regard to the portfolio company's assets, financial or earning position or related information in the financial statements or in a public invitation to acquire shares, statements in a shareholders' meeting, statements to the company's auditors, in companies register filings); or for violations of anti-bribery legislation (see question 10.4 below).

A private equity investor will generally not be held responsible for an act or a failure to act of a member of the supervisory board just because that member was nominated by that investor. However, whenever there is involvement beyond that, the investor could face criminal law penalties and civil law liability for damages (e.g. where the investor has collaborated with the member on a transaction intended to mislead another or which is adverse to the interests of shareholders (see above)). In addition, in circumstances where a sponsor nominee who, at the same time, is a decision-maker of the investor within the meaning of the Association Responsibility Act (*Verbandsverantwortlichkeitsgesetz – "VbVG"*), commits a criminal offence for the benefit of the investor, the private equity investor may face criminal law penalties and civil law liability for damages. Further, the private equity investor could face civil law liability based on corporate law for trying to influence members of the management or supervisory board to his own benefit or the benefit of another (e.g. requiring the company's management to pay the fund's transaction costs, or influencing management so that a business opportunity is not pursued and remains available for another portfolio company of the investor).

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Where a sponsor nominee director has a conflict of interest with respect to any matter, he has to inform the chairman of the supervisory board accordingly. It is then the responsibility of the chairman of the supervisory board to make sure that the sponsor nominee director does not vote with respect to the matter in question and does not participate in any related meetings.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

The following clearance requirements are typically a factor for the timetable:

- antitrust clearance (which takes four weeks if cleared in phase one proceedings (if no exemption is granted) and up to five months if cleared in phase two proceedings);
- regulatory clearance (e.g. the acquisition of a qualified or controlling interest in the banking, insurance, utilities, gambling, telecoms or aviation sector is subject to advance notification or approval of the competent regulatory authority);
- real estate transfer clearance (the acquisition of title and certain other interests in real estate by non-EEA nationals, or control over companies holding such interests, is subject to advance notification or approval (depending on state law)); and
- clearance pursuant to the Foreign Trade Act (*Außenwirtschaftsgesetz*) (the acquisition of 25% or more or a controlling interest in a business involved in certain protected industries, such as defence, security services, hospitals, emergency and rescue services, energy and water supply, telecoms, traffic or universities by a non-EEA or non-Swiss national is subject to advance approval of the Austrian Minister of Economic Affairs before signing).

With regard to timing aspects related to public-to-private transactions, see question 5.1.

4.2 Have there been any discernible trends in transaction terms over recent years?

Vendor due diligence is becoming more and more common in auctions of bigger targets (sometimes coupled with reliance and/or warranties given by the seller or the management on the vendor due diligence report, sometimes without). Similarly, warranty and indemnity insurance is more frequently discussed, in particular where private equity investors are sellers.

Specialist dept funds (see question 1.1) become increasingly relevant, not only for LBO transactions.

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5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

A typical going-private transaction involves a voluntary takeover offer aimed at control (*freiwilliges Angebot zur Kontrollerlangung*), subject to the condition that 90% of the outstanding shares are tendered, followed by a squeeze-out pursuant to the Shareholders Exclusion Act (*Gesellschafterausschluss-Gesetz*) and the delisting. A regular delisting pursuant to the Stock Exchange Act (*BörseG*) requires that the securities were listed for at least three years, that a takeover bid was published no earlier than six months ahead of the request and a shareholder resolution with at least 75% majority or a request of a qualified shareholder majority (75%).

In the context of the takeover offer, the private equity investor must ensure that the necessary funds are secured prior to the announcement of the takeover offer. The latter must be confirmed by an independent expert pursuant to the Austrian Takeover Code (*Übernahmegesetz*). The expert will typically require (i) a copy of the equity commitment letter from the fund, and (ii) copies of the definitive finance agreements together with documents evidencing that all conditions precedent (other than those within the private equity investor's sole control) have been satisfied, to satisfy itself that the necessary funds requirement has been complied with.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

Break-up fees and cost cover arrangements are quite common in private transactions (that is, transactions not involving a public takeover bid).

In public acquisitions (that is transactions involving a public takeover bid) where the target company would have to pay, they are sometimes discussed but they are not common as there is little guidance to what extent they would be valid. Common opinion is that this should primarily depend on two factors: (i) the amount of the fee (a break-up fee in an amount that will keep management from considering competing bids or deter others from considering a competing bid will probably not be valid); and (ii) the circumstances in which it is triggered (a break-up fee that is solely triggered upon active solicitation of competing bids should be valid, whereas a break-up fee triggered because a bid is not supported for good reason, or because a better competing bid is supported, is probably not valid).

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

Private equity investors tend to prefer locked box structures, particularly when they are on the sell-side. Where the gap between signing and the anticipated date of closing is long (e.g. because of antitrust or other clearance requirements), closing adjustments are the norm. Which parameters are included in a closing adjustment depends on the target business, with the most common combination being adjustments for net debt, working capital, and (sometimes) capex. Equity adjustments are the exception.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

Experienced private equity sellers will try to avoid business warranties and indemnities (and instead just provide warranties on title and capacity). In addition, experienced private equity sellers will be very keen to limit recourse for warranty claims (e.g. to an amount paid into escrow) as well as any other post-closing liability.

Where private equity sellers have to give business warranties, they often seek back-to-back warranties from management and underwrite seller's warranty and indemnity insurance or offer the buyer management warranties instead (then usually linked to buyer's warranty and indemnity insurance). The latter option has the benefit that the private equity fund need not concern himself with post-closing warranty litigation

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Private equity sellers will try to limit post-closing covenants to access to books and records and sometimes assistance in relation to pre-closing affairs. Usually buyers will insist on non-compete and non-solicitation covenants (which private equity sellers will typically try to resist). Other post-closing covenants will depend on the particular case and may include covenants on de-branding, migration, transitional services and group security interests and guarantees.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Private equity sellers sometimes use warranty and indemnity insurance to "bridge the gap". Seller policies (which protect the seller from its own innocent misrepresentation) are sometimes used but not that common. More often, buy-side policies (which protect the buyer from the seller's misrepresentation (innocent or otherwise) are taken out by the buyer, in particular where a private equity seller is not willing to back up business warranties (see question 6.2). In well-prepared auctions, flipping policies (that is a policy organised by the seller as part of the auction process which flips into a buyer's policy) are sometimes put in place early on in the process.

The typical excess is around 1% of the consideration. Policy limits vary between seller policies (usually they match the overall cap under the purchase agreement) and buyer policies (usually they start at around 20% of the enterprise value but can also cover the full enterprise value). The premium will depend on the transaction but tends to be in the range of 1–3% of the cover purchased. Typical carve-outs and exclusions include fraud, matters disclosed, matters the insured was aware of, pension underfunding and forward-looking warranties (e.g. the ability to collect accounts receivables). Indemnities for risks identified in the course of the due diligence can usually be insured as well, provided that materialisation risk and quantum can be assessed.

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6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Common limitations on warranties include:

- Time limitation for bringing claims:
  - title and capacity warranties usually survive 10 years at a minimum;
  - business warranties between 12 and 24 months;
  - tax warranties typically around seven years; and
  - environmental warranties five to 10 years.
- Financial limits, including:
  - a cap on the total liability (where there are multiple sellers, each may seek to limit its liability to the shares sold and otherwise *pro rata*);
  - a minimum aggregate claims threshold ("basket" or "deductible"); and
  - an exclusion of *de minimis* claims.
- Limitation to direct loss (as opposed to indirect and consequential loss (including lost profit)).
- Exclusion of claims to the extent caused by:
  - agreed matters;
  - acts of the purchaser (outside of the ordinary course of business);
  - change of law or interpretation of law; or
  - change of tax or accounting policies.
- No liability for contingent liabilities.
- No liability if the purchaser knew or could have known.
- No liability for mere timing differences (*Phasenverschiebung*).
- No liability if covered by insurance.
- Obligation to mitigate loss.
- No double recovery under warranties, indemnities and insurance policies.

Qualifying warranties by disclosure

Warranties are usually qualified by matters that have been disclosed (in a certain manner) or are deemed disclosed by operation of the provisions of the acquisition agreement or the disclosure letter (e.g. information which can be obtained from publicly accessible registers). The seller will always push for general disclosure (i.e. everything disclosed to the purchaser and its advisors at whatever occasion qualifies all warranties) while the purchaser will push for specific disclosure (i.e. separate disclosure for each warranty) and try to introduce a disclosure threshold requiring that a matter must be "fully and fairly" disclosed. This is usually heavily negotiated.

Limitations on indemnities

Indemnities are generally not qualified by disclosure or knowledge. The tax indemnity is usually only subject to a specific tax conduct provision, a direct loss limitation and the overall cap. Other limitations are a matter of negotiation. If other indemnities (e.g. for contamination and environmental compliance or specific due diligence findings) are accepted, limitations are usually heavily negotiated.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Private equity sellers are generally prepared to provide security but will, in turn, often require that the buyer's recourse is limited to such security (see question 6.2). Whether or not private equity buyers insist on security depends on various factors, including the set of agreed warranties and the credit of the seller (that is, where the seller is a listed corporate there is less need for security than in the case of a secondary transaction where the seller is a SPV, or where business warranties come from management only).

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Private equity buyers will typically be willing to provide a copy of the executed equity commitment letter from the fund and copies of the definitive financing agreements together with documents evidencing that all conditions precedent (other than those within the private equity investor's sole control) have been satisfied on or around the signing date, to provide comfort that the necessary funds will be available at closing. If those financing commitments are not complied with, sellers are typically limited to claims for damages. An equity underwrite of the debt component of the purchase price is rather the exception but, where definitive financing agreements are not in place at signing, experienced sellers will insist on an equity underwrite, particularly in auctions.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees as a means to limit a private equity buyer's exposure in case the necessary financing is not available at closing are not very common in Austria. If they are agreed, they are typically linked to a financing condition (that is where the financing is not available at closing, the private equity buyer can withdraw from the contract but has to pay the reverse break fee to the seller). If structured that way (i.e. a condition linked to a withdrawal right), the amount of the fee should not be subject to judicial review. Conversely, if the reverse break fee is structured as a contractual penalty for failure to close, the amount of the fee would be subject to judicial review.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

An IPO exit requires that the articles of association and by-laws be adjusted, due diligence performed and a prospectus prepared. In addition, the company will have to enter into an underwriting agreement and management will have to participate in road shows. All of that requires the cooperation of the company and (at least) where no new shares are issued, the management will typically ask the private equity seller to bear most of the associated costs (based on an argument related to capital maintenance rules). Any new shares issued in the IPO will naturally limit the number of shares the private equity seller can sell into the IPO. In addition, the underwriting agreement will usually provide for lock-up restrictions (see question 7.2) which limit the private equity seller's ability to

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sell any shares it has retained following the IPO. Finally, the private equity seller will usually be asked to give warranties in the underwriting agreement. In most cases the private equity seller will be able to limit those warranties to matters relating to the private equity fund and the shares it sells into the IPO. Sometimes director nominees are also required to give warranties in the underwriting agreement.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

The underwriting banks will usually expect some of the private equity seller's shares to be locked-up for a period of about 180 days after the IPO. In addition, lock-up requirements may already be included in the shareholders' agreement, but this is rather the exception.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Dual-track processes are rare in Austria. As far as we are aware, there have only been a few attempts in the last couple of years, all of which ultimately resulted in a trade sale.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Sources of debt finance for private equity transactions differ substantially for domestic private equity funds (which typically finance all equity or seek debt finance from domestic banks), and international private equity funds, which are able to tap the international markets. Debt-to-equity levels also vary depending on the size of the deal and are around 50% for large-cap transactions (involving international private equity funds) and 40% for mid-cap transactions.

On mid- and small-cap transactions there is usually just senior and institutional debt. On large-cap transactions it is a matter of pricing whether mezzanine is applied. High yield is typically only considered for post-completion refinancing but not for the financing of the transaction.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

Lending is regulated by the Austrian Banking Act ("*BWG*") which requires a lender to have an Austrian or passported EU licence if lending takes place (or is deemed to take place) in Austria. Specialist debt funds managed by a licensed AIFM (see the discussion under question 10.1) do not require such a licence as long as the lending business is covered by their AIFM licence.

With regard to implications on transaction structuring, please see the answer to question 2.1.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

Please see the discussion on the increased activity of specialist debt funds in question 1.1.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Usually, the private equity fund will seek to implement a tax offset structure to offset interest expense at Austrian BidCo level with profit generated at the target company level. In principle, there are two methods to achieve this:

(1) The first method is to establish a tax group between an Austrian BidCo and the target company. In such tax group, the fiscal result of BidCo and the target company is consolidated at BidCo level. If the aggregated fiscal result of the BidCo and the target company is negative, the loss can be carried forward by the BidCo to future periods. The formation of such tax group requires a tax allocation agreement and an application to the tax office. If the tax group is collapsed prior to the lapse of three years (which is the minimum period), the group members are retroactively taxed on a standalone basis.

(2) A second method, which is sometimes discussed but rarely implemented because of the significant risk it involves, is an upstream merger of the target company into BidCo. Based on past decisions of the Austrian Supreme Court, it is pretty clear that where the BidCo carries the acquisition debt for the purchase of the shares of the target company, a downstream merger of the BidCo into the target company will not be registered. In certain exceptional cases, an upstream merger of the target company into BidCo may, however, be feasible. The result of such upstream merger would be that the shares in the target company pass to the BidCo parent, interest expense on the acquisition debt can be offset against profit, and guarantees and security interests granted by the merged entity (holding the cash-generating assets) are not subject to the limitations under the Austrian capital maintenance rules (see above) and thus will be of greater value to the financing banks. In particular, the last point is of great interest to the financing banks, which is why this route is sometimes explored when a particular case supports the necessary arguments.

Regarding a future exit, it should be taken into account that double taxation treaties usually assign the right to tax capital gains to the state of residence of the exiting shareholder. If the seller is an Austrian tax resident, capital gains taxation applies (i.e. no participation exemption is available for Austrian tax residents in relation to Austrian target companies).

Avoidance of withholding taxes on dividends is usually less of an issue, since pre-exit distributions are very rare. Still, to address that issue, EU entities are usually preferred over non-EU entities and, among the latter, entities from non-EU countries with which Austria has concluded a double taxation treaty over entities from other non-EU countries.

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9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

There is no specific regime that provides for tax reliefs or other tax benefits of substantial nature to management teams. It is therefore important to ensure that capital gains taxation (27.5%) applies as opposed to taxation as employment income (up to 55%) (see question 2.3 above).

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

An exchange of shares is treated in the same way as a sale of shares and thus triggers capital gains taxation. If management only holds a small stake in the target company, the only option to roll-over into a new structure without triggering capital gains taxation is a contribution (*Einbringung*) under the Reorganisation Tax Act ("*UmgrStG*") of their shares into a holding which thereby acquires or enlarges an already existing majority holding in the target company.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

CFC Legislation

Effective as of 1 January 2019, CFC rules for "controlled foreign companies" and permanent establishments have been implemented which provide that passive and low-taxed income (e.g. interest payments, royalty payments, taxable dividend payments and income from the sale of shares, financial leasing income, and activities of insurances and banks) of controlled foreign subsidiaries can be attributed to, and included in, the corporate tax base of an Austrian parent.

Tax Rulings

Tax rulings are becoming more common, after a new ruling regime providing for binding tax rulings in the areas of reorganisations, group taxation and transfer pricing was introduced a few years ago. Since 1 January 2019, binding tax rulings are also available in the areas of international taxation and questions in connection with abuse. From 1 January 2020, binding rulings will also become available for value added tax. In practice we increasingly see ruling requests in relation to pre-exit reorganisations, but also in relation to transfer pricing issues.

Transfer Tax

There have been certain changes in relation to real estate transfer taxation (that is, a lower share consolidation threshold (now 95% compared to 100% previously) and full attribution of shares held in trust to the trustor)) which should be considered where real estate is involved.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

The most significant recent development impacting the private equity industry was the implementation of the AIFMD (EU Directive 2011/61/EU) by the Austrian Alternative Investment Manager Act (*Alternatives Investmentfonds Manager-Gesetz* – "*AIFMG*"). Private equity funds typically qualify as alternative investment funds ("AIF"). Managers of an AIF ("AIFM") require a licence from the Austrian Financial Market Authority (*Finanzmarktaufsichtsbehörde* – "*FMA*"), unless the AIF qualifies for the *de minimis* exception (which applies to managers of small AIFs with assets of less than EUR 100 million (where leverage is used) or less than EUR 500 million (where no leverage is used)), in which case such AIFs only need to register with the FMA.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

With regard to regulatory scrutiny over private equity funds, please see question 10.1 above. With regard to transactions, there is no private equity specific scrutiny. Private equity funds should, however, be aware of the general clearance requirements (see question 4.1 above).

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

Private equity buyers often split due diligence in different phases (particularly in auctions), with the first phase only covering a few value-driving items and the latter phases then covering the rest of the scope. The timeframe depends very much on whether it is a proprietary situation (in which case the due diligence can take eight to 10 weeks) or an auction (in which case the timing is driven by the auction process). Private equity buyers usually engage outside counsel to conduct all legal due diligence. Compliance due diligence is sometimes done in-house.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Anti-bribery and anti-corruption legislation had a significant impact on private equity transactions in Austria. Since their enactment, more emphasis has been placed on those areas in the due diligence process as well as in the purchase or investment agreement. Also, private equity funds (in particular bigger international investors) will make sure that a compliance system is put in place following closing if not already existing at the time of the transaction. Provided such system is appropriately monitored, it can serve as a defence for management and portfolio company liability in case there is an administrative or criminal offence by any representatives of the portfolio company under Austrian law. In addition, international private equity investors will be concerned with any

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additional requirements under the UK Bribery Act and the US Foreign Corrupt Practices Act, as both of them claim extra-territorial jurisdiction.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

In principle, a private equity investor is not liable for the liabilities of an underlying portfolio company. Exceptions apply, *inter alia*, under concepts of piercing the corporate veil, including (i) where the private equity investor factually manages, or substantially controls the management of, the underlying portfolio company (*faktische Geschäftsführung*), (ii) in cases of undercapitalisation (only where there is an obvious imbalance between the risks of the business and the equity which is likely to result in a default), (iii) where based on the accounting records, the assets of the company cannot be separated from the assets of the private equity investor (*Sphärenvermischung*), and (iv) in cases of shareholder action putting the portfolio company at risk (*existenzvernichtender Eingriff*) (where the investor takes action causing insolvency (*Insolvenzverursachung*), e.g. acceleration of a loan in distress).

In addition, a private equity investor may become liable to a creditor up to the amount secured where the private equity investor granted a guarantee or security interest securing a loan of a portfolio company in "crisis" (defined in the Company Reorganisation Act ("*URG*")). In such circumstances, the portfolio company can request the creditor to claim against the private equity investor first (in which case the recourse claim of the private equity investor against the portfolio company is suspended until the crisis is over); in addition, if the portfolio company pays the creditor, the portfolio company can take recourse against the private equity investor.

The above principles apply *mutatis mutandis* in relation to the risk of potential liability of one portfolio company for the liabilities of another portfolio company.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Most private equity investors find it difficult to access Austrian businesses, in particular where the business is family owned. For that reason, they often team up with a local partner or initiate the contact through trusted advisors.

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Florian's practice is focused on corporate and finance, in particular whenever private equity is involved. Florian is admitted to the Austrian, New York and Polish Bar. Before establishing the firm as a co-founder, Florian was a partner at Schoenherr, where he co-headed the private equity practice and was involved in some of the firm's most prestigious private equity transactions in Austria as well as the wider CEE region.

Florian has received the following awards and is ranked in/listed as:

- *Chambers Europe*.
- *Chambers Global*.
- *The Legal 500*.
- *IFLR1000*.
- Best Lawyers in Austria – (*Best Lawyers*).
- Private Equity Lawyer of the Year – Austria (*ACQ*).
- *Trend* (as one of the top 10 CEE lawyers in Austria).
- *The International Who's Who of Corporate/M&A Lawyers*.

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Clemens' transactional practice is focused on corporate and tax. He is admitted as both a lawyer and a certified public tax advisor in Austria. Before establishing the firm as a co-founder, Clemens spent six years as partner at Wolf Theiss, where he led some of the firm's most prestigious transactions. Prior to that, he practised with Haarmann Hemmelrath in Munich and Vienna, as well as with Wachtell Lipton Rosen & Katz in New York. Clemens' practice focuses on corporate and tax advice in relation to public and private M&A, private equity and corporate reorganisations (such as mergers, spin-offs and migrations), most of which have a cross-border element.

Clemens is ranked in/listed as:

- *Chambers Europe*.
- *Chambers Global*.
- *The Legal 500*.
- *IFLR1000*.
- *The International Who's Who of Corporate/M&A Lawyers*.
- *The International Who's Who of Corporate Tax Lawyers*.
- Best Lawyers in Austria – (*Best Lawyers*).
- *JUVE* (as one of the top 20 Corporate/M&A lawyers in Austria).

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Schindler Attorneys is a leading Austrian law firm focused on transactional work, with a strong focus on private equity. The members have an impressive private equity track record and an excellent understanding of the needs of financial sponsors. The firm's integrated tax practice is a key differentiator from other firms on the Austrian market and is particularly appreciated by financial sponsors. The firm usually acts for financial sponsors, but also advises banks on leverage buyout transactions.

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Belgium

Luc Wynant

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

The most common types of private equity transactions are management buy-outs (MBOs) and management buy-ins (MBIs), very often within the framework of a buy-and-build strategy. The market for these types of transactions is stronger than it ever has been since the global financial crisis. The changes in the types of private equity transactions being implemented in the last two to three years that have taken place are mainly related to the focus of investment. Firms in the professional services sector are a good example of an increased interest by private equity firms.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

The still solid economic conditions, abundant cash holdings, a strong demand and the favourable consequences they had for investors helped boost confidence in the private equity market. The legal system is well-developed, whereas corporate law provides sufficient flexibility in view of structuring private equity transactions.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

The trends we anticipate in (i) the next 12 months, and (ii) the longer term for private equity transactions in Belgium are (a) an increased use of private equity (e.g. succession of family-owned enterprises), and (b) a continued change in the investment focus of private equity firms (such as an increased focus on companies with a sustainable, social and/or environmental impact). Finding new affordable companies will remain one of the main challenges in the coming period.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

The structure most commonly used for domestic private equity funds is a Belgian company limited by shares (*naamloze vennootschap* (NV) or *société anonyme* (SA)).

The shareholders can be corporate entities or individuals, and either Belgian or foreign. The minimum share capital is EUR 61,500. In general, shares are freely transferable. However, company law permits transfers to be restricted by means of either a shareholders' agreement or a statutory clause.

There exist specific types of undertakings for collective investment (*instelling voor collectieve belegging* or *organisme de placement collectif*).

2.2 What are the main drivers for these acquisition structures?

The main drivers for these acquisition structures are the flexibility from a corporate perspective and the favourable tax conditions (including the possibility of obtaining tax rulings prior to any structuring). In 2018, the legal framework governing the *private privak* has been thoroughly revised in order to render this particular vehicle for private equity investments much more attractive.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

The equity in private equity transactions is commonly structured under the form of equity (ordinary and preferred shares), debt (shareholders' loans and/or (convertible) bonds) and carried interests and management incentives (warrants, profit certificates, ratchets or otherwise).

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Except for appropriate investor protection mechanics which can be included in a shareholders' agreement and/or the articles of

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association, there are no different structuring considerations if a private equity investor is taking a minority position.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

The typical range of equity allocated to the management will be at a level between 5% to 20% (or higher), it being understood that vesting and compulsory acquisition provisions will often be included in the investment documentation.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

It is usual for management to enter into management or employment agreements. A wide range of terms are usually imposed, including:

- Confidentiality provisions.
- Non-compete undertakings.
- Non-solicitation undertakings (in respect of employees and/or customers).

Additionally, most managers are required to forfeit all or some of their equity (or share options) in the company if they leave voluntarily or are dismissed for cause.

A bad leaver situation typically covers the unilateral termination of the management agreement by a manager (except a termination because of a material breach on behalf of the company, or a good leaver event), the infringement by the manager of material obligations (such as non-compete and non-solicitation) or in case of reasons which would qualify as cause for termination (such as fraud or wilful misconduct). The investment agreement may contain cross defaults so that a breach under that agreement terminates the service agreement.

In other circumstances (such as death, disability, permanent invalidity, serious illness, retirement or termination by the company without cause), the manager will be treated as a good leaver.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

Since 1 May 2019, the new Belgian Code of Companies and Associations (Companies Code) allows for the creation of either a single-tiered board governance structure, a two-tiered board structure or a sole director. The appointment of directors will be made public in the Belgian Official Gazette.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

A private equity investor is usually granted the right to nominate one or more members of the board of directors of the company. This right can be included in the company's articles of association (a binding nomination) but is much more likely to be found in the shareholders' agreement.

Minority shareholders can also be granted veto rights over specific corporate actions, such as:

- Use of authorised capital by the board of directors.
- Appointment of managing directors and key managers.
- Decisions in relation to certain investments, divestments, borrowing, lending and guaranteeing.

This is often achieved by issuing a separate class of shares to the minority investor and then granting veto rights to that class of shares (or to a director appointed by the investor).

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

There are no particular limitations on the effectiveness of veto arrangements at the shareholder level or at the director nominee level.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

Except for contractually agreed rights and obligations, there are no duties owed by a private equity investor to minority shareholders such as management shareholders.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Apart from certain limitations in time, there are no limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions). A non-compete provision without a geographic limitation will almost never be enforceable.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

Whether a director has acted or not within the "reasonable margin of what a normally prudent and cautious director would do in the same circumstances" is the standard for assessing directors' liability, as imposed by the new Companies Code. As a general principle introduced by the new Companies Code (with exceptions for recurrent light faults, gross faults and fraud), the directors' liability is limited to specific amounts, correlated to the size of the company, which vary from EUR 250,000 to EUR 12 million (aggregate for all directors together). In contrast, the Companies Code now explicitly prohibits exoneration and indemnification of the directors by the company or its subsidiaries.

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3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

The new Companies Code provides for stricter rules on potential conflicts of interest. A "conflicted" director has the duty to withdraw. Additionally, if the company only has one director or if all the directors simultaneously have a conflict of interest, the decision or the transaction will be submitted for approval to the general shareholders' meeting.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

The average process for a private equity transaction takes around four to six months from first contact to final closing of the transaction. Overall, the duration of the average process remains relatively stable over the years. Apart from specific regulatory approvals imposed by law (such as in relation to transactions in the financial services or telecom sector), antitrust approval is the major issue that can have a substantial impact on the timetable for transactions.

4.2 Have there been any discernible trends in transaction terms over recent years?

As the demand for deals keeps on exceeding the supply, it is extremely difficult for private equity investors to find attractive targets. Strategic buyers, foreign investors and, more recently, wealthy families and individuals are showing an increasing interest in Belgian privately-owned companies. In addition to this, aggressive debt financing in some industries further limits the amount of equity invested which subsequently leads to unseen levels of "dry powder". As a consequence, auctions are often very competitive whereby private equity investors can invest a lot of time and money with rather limited chances of success.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Other than the applicable legislation in relation to public bids, there are no particular features and/or challenges that apply to private equity investors involved in public-to-private transactions and their financing. As such, industrial bidders and private equity investors are treated in the same manner.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

There are no specific deal protections available to private equity investors in relation to public acquisitions. Break-up fees obligating the target company to pay a fee to the bidder if the bid fails are available in relation to public acquisitions, but they are not very common.

In case law, there is little guidance whether a break-up fee will be valid or not. The main factors in order to evaluate the validity of such break-up fee are (i) the amount of such fee, and (ii) the circumstances in which case the break-up fee can be triggered.

When deciding whether or not to agree to such break-up fee, the board of directors of a target company needs to take into account the company's interest.

Private equity investors can also use a more pragmatic approach in order to secure a deal in relation to public acquisitions. The shareholding of publicly traded companies is typically dominated by one or more reference shareholders. As a bidder, a private equity investor can approach such reference shareholders in order to secure the rate of success of a public offer by obtaining certain commitments from the reference shareholders (e.g. a commitment to fully support the offer and not to dispose of their shares, and/or not to solicit any bid by any third party).

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

The consideration structures that are typically preferred by private equity investors on the sell-side are the locked-box mechanism. On the buy-side, private equity investors will regularly (but not exclusively) propose a locked-box or any other similar mechanism (closing adjustment mechanism referring to, *inter alia*, net debt and working capital level). When a certain gap exists between the signing date and the date of closing (e.g. in case of antitrust approval), the consideration structure can include a kind of compensation for the intermediary period.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

Typical clauses included for the protection of contractual buyers are as follows:

- **Representations and warranties (non-management).** The purchase agreement is comprised of representations and warranties made by the sellers. A buyer is not allowed to rely on a representation or warranty if:
  - he had actual knowledge that the representation or warranty was false; or
  - he should reasonably have known that the representation was false, based on the information disclosed by the seller in the data room before the transaction was completed.

Institutional sellers are often extremely reluctant to provide any representations or warranties other than confirmation that they own the shares.

The sellers' indemnification obligations are usually limited by cap, threshold and duration and may be guaranteed by various instruments. Representations and warranties include those given in relation to tax, other financial matters, and social and environmental issues.

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- **Representations and warranties (management of portfolio company).** Management are often the only people who can make accurate representations and warranties. However, they are usually reluctant to incur personal liability by doing so. Possible solutions include:
  - limiting liability to a specified amount; and
  - requiring management to make representations only on a best-knowledge basis.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

The typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer are:

- Non-compete undertaking. A non-compete undertaking is usually requested from the management.
- Other solutions (specific indemnities and escrow). Where specific problems are identified in the due diligence, sellers can be required to indemnify against any losses arising out of those problems, regardless of whether the buyer had actual knowledge of them.

Where major problems are anticipated, or where the seller is not expected to be solvent after closing, it may be desirable to escrow a portion of the purchase price to cover indemnity claims.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

The use of representation & warranty insurance is still relatively limited but the requirement to have such insurance in place is increasingly requested by institutional investors such as private equity firms.

The typical excesses and policy limits will be 50% of deal value. Carve-outs and exclusions from such insurance policies include (i) issues known to the buyer, (ii) hazardous substances, (iii) post-completion purchase price adjustments (including leakage), (iv) pension underfunding (distinct from historic obligations), and (v) unpaid leave entitlements. Specific exclusions generally will be the condition of assets, tax losses and transfer pricing.

The typical cost of such insurance (taking into account classic retention and *de minimis* levels) will be around 1% to 1.3% (including coverage for fundamental warranties) or, when so-called "synthetic warranties" are included, 1.3% to 1.5% (percentages to be increased with insurance-related taxes).

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

The limitations are a matter of negotiation whereby the following limitations will typically apply to the liability of a private equity seller and the management team under warranties, covenants, indemnities and undertakings.

Limitations on warranties:

(i) a time limitation for notifying claims (fundamental warranties typically survive 10 years at the minimum, business warranties between 12 and 24 months and tax, social and environmental warranties the statute of limitation);

(ii) financial limits, including *de minimis*, a minimum aggregate claims threshold ("basket") and a cap on the total liability (in general, a liability *pro rata*);

(iii) exclusion of claims to the extent caused by agreed matters, acts of purchaser (outside of the ordinary course of business), a change of law or interpretation of law, or change of tax or accounting policies;

(iv) no liability for contingent liabilities or if the buyer knew or could have known; and

(v) the obligation to mitigate loss and no double recovery under warranties, indemnities and insurance policies.

Limitations on specific indemnities:

(i) Specific indemnities (such as specific due diligence findings in relation to, e.g. tax or social issues) are generally not qualified by disclosure or knowledge and are usually unlimited or limited to the purchase price (or a substantial part thereof).

Limitations on covenants and undertakings:

(i) Specific covenants or undertakings will be part of the negotiation process (e.g. scope of a non-compete provision) and, as the case may be, without any financial limitation (such as in case of a non-compete provision for management).

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Typical clauses included for the protection of contractual buyers are as follows:

- **Representations and warranties.** The purchase agreement is comprised of representations and warranties made by the sellers (see question 6.2).
- **Specific indemnities.** Where specific problems are identified in the due diligence, sellers can be required to indemnify against any losses arising out of those problems, regardless of whether the buyer had actual knowledge of them.
- **Escrow.** It is not unusual to escrow a portion of the purchase price to cover indemnity claims.
- **Non-compete undertaking (typically limited to management).** A non-compete undertaking is usually requested from the management.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

In relation to (i) debt finance, and (ii) equity finance, private equity buyers will usually provide an equity commitment letter or bank term sheet at the time of the signing of the agreement. Such commitments letter and/or term sheet will usually confirm that sufficient funding will be available at the closing of the transaction.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees to limit a private equity buyer's exposure are not

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prevalent in private equity transactions. No specific legislation is in place, nor is there any relevant case law.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

Although the IPO remains the most prestigious and profitable exit, current stock market conditions for IPOs in Belgium mean that the secondary sale and the trade sale remain the most popular forms of exit in Belgium.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

In general and subject to customary exceptions, sellers are expected to agree upon a lock-up arrangement of 180 days from the closing date, whereas as officers and directors of the concerned company are expected to agree upon a lock-up arrangement of 360 days from the closing date.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

It is rather exceptional that private equity sellers pursue a "dual-track process" whereby a company planning on an exit transaction would choose to go down the path of conducting an IPO while also pursuing a possible exit through a sale.

In case of an exit through a sale, it is common practice for buy-outs to take place by auction but there is no specific legislation covering this.

There is also no absolute fiduciary obligation to sell to the highest bidder and therefore the sellers can consider other factors when deciding which bid to accept.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Generally, a substantial part of the finance of a buy-out is provided by debt which occasionally can be as high as 80%. The usual sources of debt financing are loans from institutional investors, financial institutions and, in private acquisitions, the sellers themselves (vendor loans).

Institutional investors usually lend money directly to a company by purchasing privately placed bonds without an investment bank acting as a placement agent. There are also a number of private equity funds that provide mezzanine finance.

Commercial banks have always been one of the main sources of debt financing. Most commercial banks have acquisition finance teams that specialise in arranging acquisition finance. For larger loans, one or more banks generally arrange a syndicated facility.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

The new thin capitalisation rules stipulate that "exceeding borrowing costs" will only be deductible in the tax period in which they are incurred only up to the higher amount of 30% of the taxpayer's EBITDA or EUR 3 million (the so-called "threshold amount"). This new rule only enters into force as of 2020. In principle, the rule does not apply to loans that were concluded prior to 17 June 2016 to which, as of this date, no "fundamental" modifications have been made (i.e. modifications relating to, for instance, the contracting parties, the interest rate or the duration of the loan). For these loans and also for interest payments to tax havens, the current 5:1 thin capitalisation rule will remain applicable.

Compared to the past, the new Companies Code provides a more flexible regime for financial assistance which certainly will result in an increased use of the safe harbour regulation.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

The 2019 M&A Monitor (Vlerick Business School, May 2019) confirms that debt financing for this type of transactions is still abundant in the current economic circumstances.

Regarding the levels of debt financing, the average NFD/EBITDA-ratio is 3:5. This multiple is in line with previous years. The average (semi-)equity contribution in management buy-outs and management buy-ins (including mezzanine-financing such as preference shares and subordinated debt) is around 31%, it being clarified that, in general, the equity contribution increases with the size of the deal. For the micro-transactions, the equity-to-value ratio is 21% whereas deals with a transaction value above EUR 100 million are usually 42% equity-financed.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

The key tax considerations for private equity investors and transactions are mainly related to:

Incentive schemes

Apart from the special tax regime applicable to *privaks*, investors in any Belgian limited liability company, in general, enjoy favourable tax treatment on capital gains and dividends.

Capital gains

Except in case of a holding of less than 10% of the share capital or lower than EUR 2.5 million, capital gains realised by a Belgian holding company on the sale of shares in a subsidiary are exempt from corporate income. Capital losses on shares are not tax-deductible, except following the liquidation of a company when the capital loss can be deducted from taxable income up to the amount of the investor's paid-in capital.

Withholding tax

In general, interest and dividend payments are subject to withholding tax of 30%.

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However, many exemptions exist.

Dividends allocated by a subsidiary to its parent company are exempted from withholding tax when the parent company:

- is located in another EU Member State or in a state with which Belgium has concluded a double taxation convention; and
- has maintained a minimum share of 10% in the capital of its subsidiary for an uninterrupted period of at least one year.

As such, off-shore structures are not common.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

A common management incentive is to give the managers a combination of shares and options.

Share option plans are also often used because they can receive favourable tax treatment in Belgium. For example, it is possible to pay relatively low upfront tax at the time of the grant of the share options and to realise a tax-free capital gain, provided that the options are not exercised earlier than three years following the year of the grant (Law of 26 March 1999 relating to the 1998 Belgian Employment Action Plan). In addition, a well-designed share option plan can provide for a period of vesting (which determines when the options become exercisable).

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

The key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure are related to (i) the absence of taxation of any capital gains, and (ii) the principle of fair market value in view of management incentive plans (e.g. in case of sweet equity (such as ratchet) structures).

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

In the previous years, significant changes in tax legislation and in the practices of tax authorities (including in relation to tax rulings) have occurred which will certainly impact private equity investors, management teams and private equity transactions.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

In the previous years, significant changes in tax legislation and in the practices of tax authorities (including in relation to tax rulings) have occurred which will certainly impact private equity investors, management teams and private equity transactions.

In 2018, the legal framework governing the private *privak* was thoroughly revised in order to render this particular vehicle for private equity investments much more attractive.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

In principle, private equity investors are not subject to enhanced regulatory scrutiny based on, e.g. national security ground.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

In principle, the legal due diligence conducted by private equity investors prior to any acquisitions will be detailed and usually cover legal, financial, environmental, pensions, technical and commercial topics. A typical timeframe for such a due diligence is six to eight weeks.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

The introduction of thorough anti-bribery provisions is becoming common practice in investment documents. The provisions aim to prevent the following parties from violating any provision under any applicable anti-corruption or anti-bribery law:

- The target company.
- Any member of the board of directors.
- An officer.
- A supervisor.
- A manager.
- An agent.
- An employee.
- Any other person acting on behalf of the company.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Except for contractually agreed undertakings (such as guarantees) by a shareholder of any holding company, there are no circumstances in which (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies), or (ii) one portfolio company may be held liable for the liabilities of another portfolio company.

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11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

There are no specific factors in Belgium that commonly give rise to concerns for private equity investors. The Belgian market is very stable, relatively transparent and open for foreign investors such as private equity funds. Corporate law provides a broad range of flexible solutions in view of structuring a transaction.

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Luc Wynant is head of the corporate law, private equity and M&A practice. Luc has extensive experience in all aspects of corporate law, in particular regarding mergers and acquisitions and private equity in both transactional and financial work. He focuses specifically on international and domestic share and assets acquisitions, venture capital and debt capital markets, (leverage) management buy-outs, divestitures, funds formations, mergers and company reorganisations.

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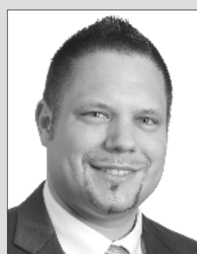
As founding partner of Van Olmen & Wynant, Luc is well-known in the Belgian legal scene and recognised as such in all major rankings.



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Jeroen Mues, Counsel at Van Olmen & Wynant, specialises in corporate law. Jeroen has over 10 years of experience and his corporate practice includes national and international transactional work for companies active in diverse industries. Jeroen specialises in (de)mergers, acquisitions, liquidations, joint ventures, corporate real estate and financing transactions and business restructurings, and has experience working for national and international non-profit organisations.

Van Olmen & Wynant

Van Olmen & Wynant is a niche law firm, covering only two areas of law: corporate/M&A and employment. This focus has been the main driver of the law firm since its incorporation in 1993.

Founding Partner Luc Wynant leads the dedicated team of experienced, multilingual professionals in Van Olmen & Wynant's corporate department. The corporate and M&A practice counsels and assists clients in all aspects of corporate law, private equity and mergers and acquisitions.

Van Olmen & Wynant is well-known in the Belgian market for its focus and its dedication to "special projects". In this respect, the firm handles more complex issues and projects such as equity structures, public and private offering of equity and debt securities, stock options, restructuring and liquidation.

Being a niche law firm is one of the core competences and the main reason clients come to Van Olmen & Wynant: clients choose our law firm for specific cases because of the experience and knowledge we have in our domains. The founding partners are well-known in the Belgian legal scene and each have over 25 years of experience in their specific niche. In this respect, the network of Chris Van Olmen and of Luc Wynant within the business world is a core competence which is not replaceable, and which is a leverage for the firm.

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Chapter 9

Brazil

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

The most common private equity ("PE") transactions are investment (acquisition) and divestment (sale) of both minority and controlling equity stakes. PE transactions are usually carried out via acquisition or disposal of equity stakes in the target company or assets with the execution of relevant documents, such as investment agreements and shareholders' agreements that foresee a set of governance rules, restrictions on transfer of shares, registration rights and rules disciplining exit strategies and creating liquidity for investors. There are no substantial changes in the way PE transactions are carried out in Brazil in recent years, and the local model of investment, as a general way of doing business, follows the patterns of other jurisdictions that are investment friendly (such as the US and Europe). Brazil has recently undergone substantial changes in its political life and trends. If the Brazilian economy recovery and consolidation is confirmed in the coming years, and paramount changes are implemented by the new elected government, it is reasonable to expect an increase of PE transactions and foreign money coming into Brazil.

In recent years, Brazilian PE funds and foreign investors have focused on middle-market companies and family businesses with strong goodwill, a bright future, sizeable growth and consolidation on the horizon. It is hard to spot a specific segment that has received more attention and money than others. We have witnessed a large variety of investment in various sectors and business segments, such as heavy industries, retail commerce, real estate, infrastructure, e-commerce, tech business, and several other kinds of services.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

The substantial upside of the opportunities, the historic legal certainty (sustained by a long-established democratic environment and the strong presence of rule of law), the tax-friendly regime for international PE investors and the little exposure of key investment opportunities to macroeconomic fluctuations are the most significant factors encouraging PE transactions in Brazil. Along with these factors, a tax-efficient ambiance to host PE investment is accounted in any investment decision.

The main factors inhibiting PE transactions are the political instability, the financial crisis and some relevant bureaucratic steps investors must face while establishing and conducting business in Brazil. Nonetheless, it is part of the new elect government's political platform to create solutions to decrease the level of bureaucracy and, as such, expedite the formation of new business entities and structures to host PE investment.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

Expedited processes of formation and establishment of businesses entities and fund formation are for sure a key element to promote a market prone for massive PE investment. Upon confirmation of the economic recovery and the consolidation of the new elected government – through the approval of several important reforms, such as the pension and the tax reforms – an increase of PE transactions in Brazil is expected, especially in the middle-market, both in the number of transactions and in their expression, and the volume of investment per deal. Until then, we expect that PE investors should probably maintain high levels of liquidity and little exposure to risks and lay low observing the political changes and market trends.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

PE transactions are commonly structured through investment funds called *Fundos de Investimento em Particpações* ("FIPs") and/or businesses entities such as limited liability companies (*sociedades limitadas*) and corporations (*sociedades anônimas*).

FIPs are regulated by the Brazilian Securities and Exchange Commission (*Comissão de Valores Mobiliários* or "CVM") and are organised as a condominium of assets. FIPs ought to have a legal administrator and an asset manager, both also regulated by CVM.

FIPs are authorised to invest in several assets issued by the target company, including shares, quotas, convertible and non-convertible bonds, subscription warrants and should play an active role in the target company's management.

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2.2 What are the main drivers for these acquisition structures?

Tax and regulatory efficiency and legal protection related to potential PE investors' liabilities. This is the reason why FIPs are the most common structure for PE transactions as these investment funds carry a friendly tax regime and a comfortable level of legal protection for PE investors. Especially regarding foreign investors, this system is both financially efficient and investment protective.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

PE investors provide funds to a FIP which, after funding, seeks opportunities to invest in target companies via acquisition of equity and/or securities. Depending on the structure designed for the PE transaction and the use of debt financing, a Brazilian business entity is formed and placed between the FIP and the target company. This format allows the FIP to hold equity of a Brazilian entity, which, as a result, will hold equity and/or securities of the target investment.

Founding shareholders are usually kept in the company in key management positions (C-level) along with professional managers and consultants appointed by PE investors.

Structures that contemplate carried interests will depend on several variables, including the PE investor jurisdiction and location of investments and investment groups.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

There are no substantial differences when it comes down to a PE transaction structure. However, when considering legal protection, different approaches should be observed when negotiating the investment, especially in the investment agreement, the shareholders' agreement and amendments to the by-laws of the invested vehicle. Minority protection should be sought first in the negotiation and afterwards in the documentation, and the mechanics to avoid abuse of control power and overwhelming situations should be contractual and easy to implement. Usually, the shelters for protection follow the patterns and solutions that are internationally available in terms of contractual provisions – with the necessary adaptations to conform with Brazilian law.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

This will depend on the amount of investment and profile of the target. Greenfield investment tends to have more aggressive option plans, whereas established business will normally apply less aggressive plans or phantom stock structures just as a reference to have variable compensation on top of fixed earnings. It is also frequent that officers and managers with options are forced to invest a percentage of their variable compensation not pegged to the stock option plan in the company through the acquisition of shares. It is also frequent to see clauses in the stock option plans where there is an effective transfer of shares to the officer or manager imposing a compulsory sale of shares back to the company if the professional resigns or is terminated for cause. This comes close to the bad leaver/good leaver clauses that are usually used in other jurisdictions. Pricing is always an issue in non-listed companies, and methodology for ascertaining the right price for the stock should be defined in the documentation.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Please see the answer to question 2.5 above.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

CVM's regulation for FIPs provides for governance requirements, including: (a) unified two-year term of office for all board of directors' members; (b) disclosure obligation for related party agreements executed by the target company; (c) choice of an arbitration chamber to settle disputes; (d) compulsory annual auditing of the financial statements; and (e) prohibition of issuance of any participation certificate including beneficiary bonds (*partes beneficiárias*).

Along with the CVM regulation, FIPs often execute shareholders' agreement with more specific governance rules and protections. That is where investors create: (a) veto rights; (b) disclosure rights; (c) rights to appoint members of the board of directors and/or board of officers; and (d) rules for specific committees.

Regarding publicity, all listed companies' corporate documents are subject to full disclosure rules. Private companies are not subject to such obligation, except for the by-laws, as they are filed and registered before the commercial registry in the state where the target is located. Any commercial registry file is public and accessible for consultation and copies.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Veto rights are typically granted to PE investors and their range depends directly on the equity stake acquired and negotiation among the underlying stakeholders. Veto rights are usually established in the shareholders' agreement and mirrored in the amendment of the by-laws to reflect voting quorum and approval processes. When PE investors take minority positions, it is normal to see a reduction in their capacity to exercise control and veto, appoint officers and managers, and step inside the life of the business. As said before, it will all depend on the size of the investment and the target's need of capital. Leverage in obtaining veto rights and control derive from several different factors where the volume of investment and the necessity to receive resources are evidently the most common ones.

Usually, PE investors have veto rights over major corporate actions such as: (a) capital increase and/or reduction; (b) issuance of securities, especially convertible securities; (c) approval of business plan; (d) approval of annual budget; (e) indebtedness; (f) mergers

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and acquisitions transactions; (g) capex investment; (h) stock option programmes; and (i) related party agreements.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

At the shareholders' level, the shareholders' agreements are binding and subject to specific performance upon the shareholders and the target company. At board level, the chairman of the board of directors must observe and meet the provisions and obligations set forth in the shareholders' agreement. As such, the chairman ought to refuse to cast a shareholder vote exercised against the terms and conditions provided for by the shareholders' agreement to which such shareholder is a party to. Often, shareholders' agreements grant proxies to other shareholders to ensure that the shareholders will exercise their voting rights in accordance with the terms and conditions of the agreement.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

PE investors are no different from other shareholders. There are no special duties and/or obligation that PE investors should be aware of when dealing with a Brazilian PE transaction. PE investors should exercise their voting rights in the target's best interest (just like any other shareholder of the company) and develop the business in accordance with their corporate goals and approved business plan. Brazilian law foresees additional rights and obligations to controlling shareholders and, therefore, PE investors should be aware of such rights and obligations if interested in acquiring controlling equity stake in Brazilian companies, especially in publicly held companies. Special attention should be directed to the rules that govern abuse of control power and exercise of voting rights to overwhelm minority interest.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Shareholders' agreements may be governed by a foreign law, but that is unusual due to the complex, time-consuming and expensive procedure to recognise a foreign judgment in Brazil, and the fact that most shareholders' agreement effects take place in Brazil. Having a shareholder agreement governed by foreign law and subject to any other jurisdiction is a factor that will add complexity to its enforcement.

Non-compete and non-solicitation are fully enforceable so long as investors pay attention to certain requirements – payment of compensation, territory limitations and time limitation of up to five years. PE investors should draft detailed provisions highlighting the terms and conditions of non-compete and non-solicitation arrangements to avoid enforceability issues.

The main requirement to secure the enforceability of the shareholders' agreements is that the document is filed before the target company. Following the consummation of the deal, PE investors should follow up bureaucratic steps and make sure the shareholders' agreement is being kept and is available in the files of the target company. This formality can be satisfied by having the target company as an intervening party to the agreement.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

Appointed members should meet some relevant requirement to qualify for the position either as a director or as an officer. They should carry a clean slate, and not have been sentenced for crimes related to fraud, misappropriation of funds, bankruptcy fraud, bribery and any other sort of engagement in corruptive practices, embezzlement, racketeering, and any other legal sanction that would bar the individual from taking a fiduciary position, where care and loyalty are of the essence of the mandate.

Management may be held jointly liable for the target company's obligation in certain cases, especially regarding the company's labour, social security and/or tax obligations. Brazilian judges tend to follow aggressive approaches against officers and directors in case of unpaid labour wages, taxes and social security obligations.

In the digital era and with cases running on virtual records and courts fully connected to the banking system, judges and clerks have achieved a huge capacity of finding assets and cash via electronic foreclosure of funds. Involvement of managers in claims are usually related to abuse of power and/or breach of law and/or the company's by-laws.

Most common liability protection for officers and directors are the D&O insurance and indemnification and hold harmless agreements.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Directors must always act in the best interest of the business and be bound by their duties of care, loyalty, and have focus on their fiduciary responsibility. Once they undertake their mandate, it does not matter which is the specific interest of the party that nominated them, as they will always have to apply their best judgment in the benefit of the target company. They are also barred from voting on any matter involving a conflict of interest. Taking other management positions in portfolio companies does not directly affect their impartiality and eligibility to exercise the management position at the target company. The conflict of interest arises from taking positions or defending interests that are clearly against the best interest of the company where the director is occupying a seat.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

FIPs must be registered before the CVM. There are special features and rules that apply to non-resident investors of the FIP:

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- appoint one or more representatives in Brazil (Resolution 4,373/14, Brazilian Central Bank), which must be either financial institutions or an institution authorised by the Brazilian Central Bank to perform this duty;
- appoint a representative for local tax purposes; and
- appoint a local securities custody services agent.

As to regulatory aspect, PE transactions within regulated sectors will require prior authorisation of the competent authorities most of the time.

In what pertains to antitrust approvals, Section 88 of the Brazilian Antitrust Act defines that the antitrust authority (*Conselho Administrativo de Defesa Econômica* or "CADE") must be notified of any concentration act, in any economic sector, where at least one of the groups involved in the transaction has registered annual gross sales or a total turnover in Brazil, in the year preceding the transaction, equal to or greater than R$ 750 million, and at least another group involved in the transaction has registered annual gross sales or a total turnover in Brazil, in the year preceding the transaction, equal to or greater than R$ 75 million.

The control of these concentration acts will occur prior to the transaction; that is, until CADE's final decision, the conditions of competition between the companies involved must be maintained.

When analysing a concentration act, CADE observes, for example, the market share of the companies involved in the transaction and whether there is rivalry on the part of competitors, in addition to other aspects related to the sector under analysis. CADE ensures the preservation of competition, aiming, among other things, at the diversity and quality of products and services provided to consumers.

After completing the analysis of the concentration, within 240 days (extendable for another 90 days), CADE may approve the transaction (with or without restrictions) or simply reject the transaction.

4.2 Have there been any discernible trends in transaction terms over recent years?

It is expected leveraged PE transactions regain speed with the decrease of the interest rates and the flexibilisation and development of the credit environment. Anticorruption diligence is currently a concern for PE investors. Since *Operação Lavajato* and the enforcement of the Brazilian Anticorruption Act (Law no. 12,846/13), PE transactions within regulated sectors have become more diligence intense and subject to a tighter compliance scrutiny not only on legal and financial aspects, but also on the target, its officers and directors.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

A public-to-private transaction usually take place either by:

- a private agreement executed between the PE investor and the target company's control group, which ought be followed by a mandatory tender offer ("MTO") in case of a controlling stake acquisition (the MTO is a feature to protect minority stake, securing to minority shareholders similar financial conditions that were given to the control group); or
- a direct, straight tender offer to acquire the control of the target.

In recent years, especially during the era of intense IPO activity in Brazil, the adoption of protective measures against attempts to gain control via public offers became frequent. To such extent, PE investors usually face typical poison pills provisions mechanics and/or competition or interference of other investors interested in acquiring the target company's stake. Protective mechanics have for sure lowered the speed of PE investors and the number of public deals in place.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

There is no specific shelter or protection for PE investors in public acquisitions. PE investors interested in deal protections for public-to-private transactions should consider the same deal protections available for private transactions. Break-up fees are legal in Brazil if they are set at reasonable levels and created in the best interest of the business and its shareholders. Nonetheless, they are more frequently found in a context where private investment is running into a closely held business rather that in a public acquisition.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

On the buy-side, PE investors look for structures with the highest quality, value and number of guarantees, payments in instalments, escrow accounts and/or earn-out provisions to protect from the target company's pre-closing liabilities. On the sell-side, PE investors prefer structures with indemnification limitation and caps. Usually, both sides negotiate representations and warranties provisions.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

The package is directly related to the size of the investment and of the equity stake of the transaction and the participation of the PE investors in the company's management. For passive or non-controlling PE investors, the maximum package should be representations and warranties whilst for active and/or controlling PE investors the package should encompass indemnification obligation, earn-out provisions and/or escrow accounts to hold the entire or part of the PE transaction value for a certain period and subject to certain milestones agreed by the parties.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

PE investors and managers/administrators will keep the target company in the ordinary course of business until closing date, setting out in the documentation the parameters under which the business will run, and a basket of actions and limitations to be followed until such time when conditions precedent are cleared, and financial closing takes place. Sellers are usually responsible for pre-closing liabilities and to indemnify PE investors from and against any losses incurred due to facts and/or acts that occurred prior to the

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PE transaction closing date. In essence, a PE deal from this perspective happens under the same format of ordinary mergers and acquisitions transactions.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Representation and warranty and indemnities insurance are not common in Brazilian PE transactions.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Limitations are often related to time and cap. Such limitations are usually related to the result of the due diligence process and to the commercial negotiations among the parties.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Once again, the format is very similar to any M&A transaction and largely depend on negotiations. It is somehow difficult to set a pattern or a formula. The types and levels of security are defined in each case. The buy-side normally goes for segregation of funds in escrow, price hold-backs, and even liens on shares. The security is usually tied to what is found in terms of liabilities during diligence and its release normally follows the term set for the parties' responsibilities under the investment documentation – and most of the times it is usually a pre-defined drop-dead date for potential liabilities or terms associated with the statute of limitations, for example, in tax and labour exposures. When the PE investor is selling its stake and exiting the investment, it becomes a little more complex given that after the distribution of proceeds to investors, indemnification is no longer viable. In this case, escrow accounts appear as a good solution.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

PE investors normally comfort sellers showing their commitment to meet all the financial obligations under the investment documentation. Such comfort may come in different formats, such as a commitment to call capital on the investors once all the conditions precedent are met and the deal is mature for financial closing or, yet, showing to sellers that debt or equity finance are in place. If the PE investor fails to meet what has been agreed in the documentation, sellers may seek court relief to enforce their rights under the investment commitments. Specific performance is available as per the federal rules of civil procedure and also damages. However, defining the right litigation strategy largely depends on the specific case, nature of the breach, liquidity of the PE investor to pay for the purchase price or raise the capital of the target (depending on whether it is a primary or secondary sale of shares), and what has specifically gone wrong between signing and closing.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are not common in Brazil.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

The PE investor must be fully aware of how the process runs in Brazil and how you take all the necessary steps that will ultimately take you to an IPO. Hiring the right consultants and financial advisors and understanding the intricacies of local law and securities regulation is of the essence in this process. However, knowing these steps and siding with the right professionals is not the key driver to an IPO. As anywhere else, the decision to go public largely depends on market conditions. Brazil has built an efficient and sophisticated capital markets environment, especially after the IPO boom that took place a few years ago. This boom allowed Brazil to build a substantial evolution in the capital markets and attract foreign players to invest in the stock exchange – and the development of high standards of governance and strict rules of compliance added an extra layer of trustworthiness to our system. The roles of CVM and Bovespa have also been a key factor to build confidence to investors and create the right track to go public in Brazil. However, the most relevant elements in igniting a going-public process are market conditions and liquidity in the capital markets. As we have explored here in this chapter, Brazil is facing political changes, which are dependent on immediate reshaping of its fiscal and monetary policies. The next two years, along with the capacity of the new government to implement these changes and drive congress into taking its ideas and political agenda, will determine whether investors will find a comfortable environment to undertake risk and find an exit through an IPO. An exit through an IPO does not, at this moment, appear to be the best alternative for a PE investor.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

It is reasonable to expect that a PE investor with a minority stake (either exiting or staying in the business), will be averse to accepting any lock-up. For larger stakes, and if the PE investor is vested with control power and holds a relevant share position in the business, a six-month lock-up is usual and acceptable.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Usually, when using a dual-track exit strategy, investors hold until the very last moment before the deal becomes public – which happens after the initial filing at CVM and before disclosing the

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prospectus. From what we have seen, dual-track deals are usually consummated via IPOs.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Most common sources of debt to finance PE deals in Brazil are loans and bonds (debentures) – or a combination thereof. Local banks are the financial institutions that ordinarily extend credit and underwrite the issuance of dentures to foster the PE market. As we have pointed out above, Brazil is undergoing relevant changes in its political life. Several measures that have been lined up by the new Government hold the clear purpose of promoting changes in the economic environment, redirecting the country to a fast-pace GDP growth, the creation of new jobs, and attraction of foreign investment. If, in fact, we see a turnover in the coming years, and upon the recovery of the Brazilian economy and the consolidation of the new government, access to credit and the high-yield bonds market is expected to increase. With a new reality in place, an increase of PE investment – especially from foreign sources of funds – is likely to happen.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

This should be analysed on a case-by-case basis, as legal requirements and/or restrictions are directly related to the debt financing structured for the PE transaction. But it is relevant to note that FIPs, by their nature, have limitations to take debt. Thus, when the PE investment runs through a FIP, and there is debt associated with the funding of the acquisition, an intermediate company will have to be capitalised with equity from the FIP and the amount of debt extended by the creditor. Please see the answer to question 8.3 regarding new changes to such limitations.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

Recent changes to the CVM regulation for FIPs have opened more latitude for the funds to take debt, allowing the FIPs, as a consequence, to incur debt in certain situations (such as debt from market development agencies), with a limitation of up to 30% of the FIP assets.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

In view of the applicable tax benefits, the most common structure for private equity investments in Brazil is the incorporation of an equity investment fund, the so-called FIP. The use of such structure has the following advantages:

- income and gains from investments are tax-exempt, as taxation is deferred to the moment of the redemption of shares by the FIP investors. Note, however, that in case of investments profits by the payment of dividends, one shall bear in mind that dividends are tax-exempt in Brazil and in case it is paid to the FIP, the profits related thereto will be taxable by the time of the redemption of the shares; and
- non-resident investors holding shares in FIPs may also be exempt from income tax upon redemption of FIP shares, so long as certain conditions are met. Therefore, off-shore structures are commonly used to enjoy the benefit of such exemptions and maximise profits.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Tax applicable to private equity investment, as well as the most efficient investment strategy to be followed, will vary depending on several issues, such as the origin of the funding, the characteristics of the investment and if the investors are foreign or local residents. Therefore, the analysis of the most tax-efficient arrangement to be followed should be made on a case-by-case basis. Nonetheless, the incorporation of a FIP is often considered as the main tax-efficient arrangement for private equity transactions in Brazil, especially when foreign investors are involved.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

When selling and/or rolling over investments into new acquisition structures, the key tax considerations are related to taxation on capital gains. Rolling-over investment into new acquisition structures are usually made by means of a contribution of assets into the new vehicle, as it is usually tax-neutral. However, when the new structure is a FIP, the neutral tax effect of the transaction may be frustrated. There are cases that the law requires that the valuation of the assets to be rolled-over be made based on the fair market value of these assets, in which case the applicable taxes would have to be levied and paid by the investor at the time that the transaction is finalised and capitalisation takes place.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

There are bills of law currently undergoing legislative analysis to change the tax regime applicable to investments in close-end investment funds, such as the FIPs. According to such bills, accrued profits until March 2019 should be subject to taxation. Additionally, the tax regime applied to funds should depend on how it is framed under the CVM regulation. FIPs qualified as investment entities should be subject to taxation upon the realisation of capital gains at the time of the disposition of assets; FIPs qualified as non-investment entities should be subject to the same tax treatment applied to other Brazilian business entities, such as corporations. In case any of the current bills of law pass congress approval, the use of FIPs for private equity investments will have to be re-evaluated by the investment community, since the tax efficiency of the deferral

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of taxes to the moment when the shares are redeemed by the investors will no longer be available.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

In addition to the changes to the tax regime, over the recent years CVM has promoted a series of changes in the regulation of the Brazilian capital markets, including the regulatory framework applicable to FIPs.

Among others, the main changes implemented are:

- classification of FIPs into categories according to the composition of their portfolio (seed capital, emerging companies, infrastructure, intensive economic production in research, development and innovation and multi-strategy);
- restriction of FIPs to qualified investors as defined by the CVM regulation;
- permission to invest in limited liability companies and to make advances for future capital increases (the so-called "AFAC");
- permission to invest in non-convertible debentures;
- flexibilisation of the influence obligation over the target company's management;
- possibility of investing in quotas of other FIPs;
- authorisation for operations with derivatives; and
- authorisation for investing abroad.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

As mentioned above, PE transactions covering regulated sectors (banking, insurance, healthcare, public utilities, etc.) are often subject to prior approval by the competent authority, as these sectors are deemed to be of national interest and security and, as such, protected by principles of public policy. Therefore, transactions involving these segments tend to run under a stricter scrutiny and with higher levels of analysis by the regulatory agencies and other government bodies and subdivisions.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

Due diligence ordinarily follows the same pace and levels of details of any other M&A transaction. Usually, the PE investor engages a team of consultants, wherein financial advisors and lawyers lead off discussions along with the investor. The work itself is quite the same: finding the right valuation; negotiating investment conditions; putting up a capital structure to head to a successful closing; and assessing all liabilities that could affect value and impact the future of the business. These days, compliance has taken a substantial role in the diligence phase, and sometimes even its own independent path. It is not uncommon to see international compliance auditors coming on board to join the diligence team and screen the business, its practices, relations with public officers and government at all levels, and also run a full-blown check on officers and directors to build the right profile and ascertain that there is no liability pegged to their professional performance.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

As mentioned at question 10.3, this has become the hot topic either in diligence or in post-closing actions. It starts with the confirmation that both the company and its individuals carry clean slates, have conducted the business of the target with high moral, ethical and legal principles and values and without leaving hidden liabilities or unorthodox practices behind. After closing, and depending on the level of safety of the original compliance practices, PE investors tend to raise the bar and strengthen the internal policies in all segments: government relations; interactions with inspectors; supply chain; and acquisition of goods and equipment. This is a new trend and has enabled the Brazilian business community to better understand how compliance works in the international scene.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

As a rule, this is not possible. The applicability of the disregard doctrine in Brazil is very limited, the local federal rules of civil procedure and case law are very tight, and the test to pierce the corporate vail and reach the shareholder pocket is far too narrow. Unless there is strong evidence of fraud supporting a claim to disregard the legal entity, the general rule is that liabilities should be a burden of the target company and plaintiffs should have recourse only to the corporate assets and funds. As we have seen above, some labour courts are more aggressive in implicating officers and directors with fiduciary responsibilities – and the same could happen in consumer relations and environmental exposures. It is also uncommon for a plaintiff to direct claims against other portfolio companies for the simple fact that they are controlled by the same PE investor or PE fund; not only is this uncommon, but also risky in terms of litigation strategy, in that the federal rules of civil procedure foresee that in any civil action the defeated party ought to pay for attorney fees and court expenses. This rule normally stops moving parties from taking frivolous civil actions and shopping for a deep pocket.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Brazil is a litigation-prone environment and it is of common knowledge that our courts are busy. It is normal to find some jurisdictions with literally clogged dockets and lengthy civil procedure and labour litigation processes. This reality is normally reflected in the life of target companies, wherein an investor is likely to face a long list of procedures on a variety of matters. Due diligence on the litigation basket should always be carried out

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thoroughly, especially in a labour-intensive business. Usually, the liabilities expressed in pending litigation, regardless of their nature, may cause a material impact on the investment and/or on the initial valuation of the business – which, as a natural consequence, will impact the projected return on the allocation of funds.

The current political situation is also a sensitive issue to be observed. Brazil has changed its ideological orientation in the last election, and the challenges to be faced by the new office are neither few nor irrelevant. The first quarter of the new government has shown that the legislative approval for fundamental changes on the public pension funds structure and tax framework will demand political ability, capacity to compromise, and strong articulation with opposing parties. All the stability in the financial markets that create the confidence base to host investment and undertake risk (both for domestic money and foreign resources) are yet to be established. We have the view that today all the gates and hurdles to unleash a race of private investors into Brazil are tied to the definition of the country's political future for the next four years.

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Lampert was an executive officer of LLX Logística S/A, the largest private integrated logistics project in Latin America, where he was able to develop and head into operation with two super ports in Rio de Janeiro – Porto Sudeste, a bulk terminal with capacity to handle 50 million tons of iron ore per year and Porto do Açu, a multi-cargo terminal, with capacity of handling bulk, general cargo, and oil transshipment and storage. In this phase, as an executive of LLX, he has also led the institutional work of the company in the legislative process to change the legal framework of the port sector, which ultimately lead to the enforcement of Law 12,815/13, the new Port Statute that currently guides investments in the sector.

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Before joining Faveret Lampert Advogados in 2015 as founder, Sartini worked in prestigious law firms such as Barbosa Mussnich e Aragão Advogados and Vieira Rezende Advogados, and financial institutions such as Oliveira Trust and BNY Mellon, always in the area of Corporate Law and Capital Markets.

Sartini has relevant experience in the corporate and capital market practice, particularly in the negotiation and execution of complex corporate matters (including M&A transactions, structured transactions, public placements, private equity industry and corporate reorganisations), companies' projects and restructuring, and regulatory matters before the CVM. Such experience allowed Sartini to also work in several arbitrations and commercial litigations related to the areas.

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We are a business law boutique headquartered in Rio de Janeiro (offices in Downtown and Ipanema), currently acting for some of the largest companies in Brazil. We have a proven track record of working in large and complex projects and a solid and dedicated team to oil and gas transactions. Our expertise in the field comprises the entire value chain, from production (upstream), LNG (including regasification and sales) to transportation pipelines, processing facilities, petrochemicals and the marketing and trading of fuels.

Our clients benefit from the direct and continuous participation of the senior partners in the work and from the experience that they have gained by being involved in some of the most complex cases, transactions and projects in recent decades in Brazil.

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Canada

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

Canadian private equity deal activity remained high in 2018, resulting in the second highest total deal value of the decade with an aggregate value of over $52 billion. The Canadian market continues to be viewed very attractively by foreign entities, especially U.S. investors, driving significant U.S. participation. The trend of larger-sized deals continued in 2018, with the Canada Venture Capital Association reporting that $1 billion+ deals accounted for 65% of private equity dollars invested in Canada in 2018.

In terms of industries, industrial and manufacturing captured the largest portion of private equity investment in Canada in 2018 (22%) followed by information communications technology and consumer and retail.

Continuing the trend of recent years, add-on deals accounted for nearly two thirds of Canadian private equity deal activity in 2018. With Quebec and Ontario leading the way in terms of both numbers of deals completed and value of dollars invested.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

There was a steep decrease in PE fundraising in 2018. This is likely indicative of a market correction reflective of the large amounts of dry powder that funds currently have to be deployed. As such, the seller's market continues. Private equity firms are flush with capital and Canada is highly ranked by a number of sources as an attractive country for foreign companies to invest in. The Canadian political scene continues to be stable and the legal system is fully developed and similar, in many respects, to the American system. Those factors, coupled with the comparatively low valuation of Canadian dollar, have created favourable conditions for private equity activity in Canada, in particular, by non-Canadian investors.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

Market conditions are expected to continue to favour sellers through 2019 given the large amount of dry powder waiting to be deployed by private equity firms and the increasing interest in the market from U.S. private equity investors. As a result of these conditions, auction sales processes have been growing both more common and more competitive, often with multiple bidders proceeding through to advanced stages of the bid process. This is increasing the "cost-to-play" and is pressuring bidders to offer both higher prices and more seller-friendly transaction terms such as weaker indemnification packages, smaller escrow sizes and shorter survival periods for fundamental representations and warranties.

While dual-track exit processes have not historically been the norm in Canada, they were increasingly popular in 2018 and, if market volatility continues through 2019, this trend will likely continue, at least for more significant exits.

If the available dry powder and the competition for assets continue to grow, private equity firms can be expected to apply the same strategies in Canada that are emerging as solutions to similar problems in the U.S. and globally. Many of these tactics involve firms decreasing their reliance on their traditional buyout activities to drive returns. Such strategies include increasing buy-and-build or add-on activity to arbitrage deal multiples, using large-scale mergers that can compete with strategic buyers and diversifying fund offerings.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Privately held Canadian businesses are generally acquired by private equity buyers either through a purchase of assets or a purchase of shares. Private equity investors will typically incorporate a Canadian acquisition corporation and fund it by way of interest-bearing debt and equity on a 1.5:1 basis in order to comply with Canadian thin-capitalisation rules. This acquisition entity then acquires all of the shares/assets of the Canadian target and, in the case of a share acquisition, the acquisition corporation and target are then "amalgamated" under the relevant corporate statute to align the leverage with the operating company. Often,

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these buyout structures include key management rolling their interest and maintaining their equity stake. The then amalgamated operating company will then typically make add-on transactions by way of direct acquisition whereby the operating company will acquire the share or assets of an add on target directly.

While buyouts remain the preferred form of investment, private equity investors taking minority positions, once only common in smaller growth equity deals, continues to be an increasingly popular trend.

2.2 What are the main drivers for these acquisition structures?

Whether a Canadian acquisition should be completed by purchasing assets or shares is driven by tax and non-tax considerations. The weight given to these factors will depend on the circumstances of the transaction and the parties' ability to leverage their respective positions. From the point of view of a potential purchaser, the greatest benefits of an asset sale are tax advantages and the ability to pick and choose the assets and liabilities that will be acquired. The majority of "legacy liabilities" can be left with the seller. However, asset sales tend to be significantly more complex in larger transactions and can require more third-party consents for material contracts. In contrast, a share sale is relatively simple from a conveyancing perspective and less likely to trigger third-party consent requirements. From the seller's perspective, tax considerations generally favour share transactions as individual sellers may be able to utilise their $866,912 (as of January 1, 2019) lifetime personal capital gains exemptions to shelter a portion of the proceeds. "Hybrid" transactions, which involve the acquisition of both shares and assets of a target entity, providing tax advantages to both buyer and seller, also continue to be popular.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

Sellers of businesses, including key management, will often rollover equity into a corporate purchaser. The precise terms of the equity interests offered to, or required of, continuing management are often a major point of negotiation in transactions. Typical structures include multiple classes of equity with one class designed to pay out investors, such as the fund and any co-investors (including management), in priority over a second class designed to pay out continuing management only if the business is eventually sold for more than a certain threshold value (incentive equity). Stock options (more tax effective) or phantom stock options (less tax-effective) are also commonly granted.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Minority positions require private equity firms to consider different structuring issues due to the lack of control. The minority rights stipulated in the shareholders' agreement become of primary concern to ensure private equity firms have veto power (or at least significant influence) over critical decisions. Likewise, put and drag-along provisions are key to ensure the private equity investor has flexibility with regards to their exit strategy. A minority interest is often taken in the form of convertible preferred shares or a convertible debt instrument.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Allocation to management will vary on a deal-by-deal basis but typically ranges from 10–20%.

Aligning the equity interests granted to continuing managers with the continued growth and success of the company is essential. In order to align interests, most stock option plans call for options to vest and become exercisable upon the achievement of certain conditions. Those conditions are typically tied to either continued employment and the passage of time, and/or certain performance/success requirements, such as the achievement of stated financial returns.

Generally, management equity is structured to allow for repurchase by the company upon a termination of employment. Options granted to management may vary on whether they are exercisable following termination of employment based on whether the termination was a "good exit" or a "bad exit" or on where the management ultimately lands following the exit. The options granted to management typically vest automatically in the event of a sale of the company by the private equity investor.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Under Canadian law the threshold for firing an employee "for cause" is very high and hard to establish. For that reason, circumstances amounting to an exiting management equity holder leaving as a "bad leaver" are not tied to a causal dismissal but rather to more general grounds of dismissal. Any circumstance where an exiting equity holder is terminated or is acting in competition with the business will be treated as a "bad leaver". Good leavers are usually those leaving due to death, disability or retirement.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

Private equity firms utilise their equity positions, or negotiated minority rights, to assign seats on the board of directors to their principals and nominees. As such, they typically have the authority to run the portfolio company for the period of their investment. In Canada, the names and addresses of private companies' boards of directors are publicly available information. However, the names of shareholders of private companies are not currently publicly available. There is pressure being brought by foreign interests on Canadian regulators to bring the disclosure of ownership of Canadian corporations into alignment with other major countries. A recent amendment to the *Canada Business Corporations Act* now requires federally incorporated businesses to maintain a record of beneficial owners in their corporate records. While this information is not publicly disclosed, it is indicative of a trend towards more transparency that we expect to see continue in Canada.

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3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

The default dissent rights provided under corporate legislations are typically supplemented through unanimous shareholder agreements that ensure the private equity investor has ultimate control over the portfolio company. Often, such veto rights cease to apply where a private equity investor's equity interest is reduced below a given benchmark.

Where a private equity investor holds a minority position, veto rights are still typically enjoyed over critical business matters such as acquisitions, changes to the board and management team, the issuance of new equity or debt and the disposition of key assets.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

In order for a shareholder agreement that sets forth veto arrangements to be enforceable against a subsequent shareholder, to fetter the discretion of the directors or to supplant the default provisions of corporate legislation where permitted, it must be unanimous in nature. At the director level, only certain director discretion can be fettered by a unanimous shareholders' agreement and, most notably, the fiduciary duty directors of portfolio companies owe to the company cannot be restrained.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

In contrast to some American jurisdictions, controlling shareholders in Canada do not owe a fiduciary duty to minority shareholders.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

A shareholder agreement that is not signed by all of the shareholders of a company is treated as a regular commercial contract. It is subject to the articles and by-laws of the corporation and the provisions of the relevant corporate statute. In contrast, a unanimous shareholder agreement ("USA") is a creature of statute and must be signed by all shareholders. Corporate legislation expressly recognises the ability of shareholders to contract out of certain statutory requirements and fetter certain powers of directors.

To the extent the USA restricts the powers of directors to manage the business and affairs of the corporation, shareholders who are given that power inherit the rights, powers, duties and liabilities of a director under corporate statutes or otherwise.

Canadian courts will generally not enforce restrictive covenants that unnecessarily restrict an individual's freedom to earn a livelihood. What is reasonably necessary depends on the nature of the business, its geographic reach, and the individual's former role in that business. Canadian courts will not enforce a restrictive covenant that does not contain any time limit.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

Depending on the jurisdiction of incorporation, the board of directors of a Canadian corporation may be subject to certain minimum residency requirements. Notably, boards of directors for companies incorporated under either the federal or Ontario statute must consist of at least 25% resident Canadian directors or include at least one resident of Canada if the board has fewer than four members.

In Canada, all directors owe fiduciary duties to the corporation, including a duty to act in the best interest of the corporation. The potential statutory liabilities directors are exposed to can be extensive and the basis for this potential liability varies. Directors may be personally liable for their own wrongdoing or failure, such as breaching the duties of loyalty and of care, or, in other instances, held personally liable for wrongdoing by the corporation. The statutes that impose director liability include those governing: corporate matters; securities compliance; employment and labour protection; taxation; pensions; and bankruptcy and insolvency.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Directors of a corporation who are nominees of a particular shareholder are subject to fiduciary duties to act in the best interest of the corporation, not the shareholder who nominated them.

Canadian corporate statutes require directors to disclose in writing the nature and extent of their interest in a proposed material contract or transaction with the corporation. This provision applies whether the director is a party to the contract or transaction personally or is a director or officer of, or has a material interest in, a party to the contract or transaction. As such, all conflicts or potential conflicts the director has, as a result of their relationship with the nominating party and/or other portfolio companies, must be disclosed. In situations of conflict, the statutes require the director to refrain from voting on any resolution to approve the contract or transaction except in narrow circumstances.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

Aside from the typical due diligence process, the timetable for transactions is often governed by the regulatory approval required under the *Competition Act* and the *Investment Canada Act*, where applicable.

In Canada, certain large transactions trigger advance notice requirements under the *Competition Act*. Such transactions cannot be completed until the end of a review period. Pre-merger

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notification filings are required in connection with a proposed acquisition of assets or shares or an amalgamation or other combination to establish a business in Canada where thresholds relating to the "size of the parties", the "size of the transaction" and "shareholding" are exceeded. Recent amendments to the *Competition Act* may result in more transactions being subject to pre-merger notification as all corporate and non-corporate entities under common direct or indirect control are now treated as "affiliates" and will thus be included in the threshold analysis. This will be especially impactful on traditional private equity funds that are structured as limited partnerships.

In addition to competition regulations, under the *Investment Canada Act*, foreign investments that exceed prescribed values or that relate to a cultural business or involve national security issues are subject to *Investment Canada Act* approval. This allows the federal government to screen proposed investments to determine whether they will be of "net benefit" to Canada.

4.2 Have there been any discernible trends in transaction terms over recent years?

The increase in foreign investment, typically from the U.S., has influenced transaction terms which have gradually shifted to become increasingly similar to those in the American market. For example, the size of indemnity caps, while still significantly higher in Canada than in the U.S., continue to trend downwards and the Canadian market has increasingly seen "public style" deals, as has the U.S. market. As well, as the use of representation and warranty insurance continues to be increasingly common in the Canadian private equity market and impacts what terms are "market" in deals using that product. For instance, double materiality scrapes are now very typical in representation and warranty insured Canadian transactions.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Canadian takeover bids require that adequate arrangements (an interpreted statement) must be made, with the effect that a bid cannot be conditional on financing. Statutory plans of arrangement on the other hand can be conditional in nature and allow for more flexibility to provide collateral benefits to managements, etc. Due to this flexibility, most uncontested Canadian privatisation transactions involving private equity investors are completed by a plan of arrangement.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

In friendly acquisitions, break fees are often seen in connection with "no-shop" provisions. The "no-shop clause" is typically subject to a fiduciary out, upon which the break fee becomes payable. The break fee, traditionally in the range of 2–4% of the transaction's value, is now typically based on enterprise value.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

Private equity buyers typically require purchase price adjustments to reflect the financial condition of the target. Typically, these are based on a net working capital adjustment. Earn-out provisions are also often contemplated by private equity buyers in order to link the seller's ultimate consideration to the financial success of the target entity post-closing. The use of "locked box" structures, common in the UK, has also become a more common structure in Canada as a means to limit post-closing price adjustments.

Private equity firms generally arrange their own credit facility and invest on a cash-free, debt-free basis. On the sell-side, private equity investors typically prefer simple consideration structures with less variability, and that minimise the size and scope of post-closing obligations.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

Private equity sellers and management teams will try to minimise the representations and warranties and insist on a short survival period for representations given. Private equity sellers will further try to limit their exposure by ensuring they do not include a full disclosure, 10b-5 type and representation by liberally using materiality qualifiers and by including an anti-sandbagging provision. Private sellers are also increasingly insisting on public-style exits.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Private equity sellers generally insist on limiting post-closing exposure as much as possible. As referenced above, they typically limit the length and scope of indemnity provisions as much as possible, as well as other post-closing covenants and undertakings. Public-style exits, where a private equity seller's post-closing exposure is only limited to instances of fraud, are becoming increasingly common.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

2018 saw a marked increase in the use of representation and warranty insurance in Canada which is now widely used on Canadian private equity transactions. Policy limits typically cap out at 10–20% of the purchase price of a transaction. Over recent years the number of typical carve-outs and exclusions from such policies has decreased quite significantly but they remain for pre-closing taxes, pension funding, certain environmental matters and other high-risk deal specific terms. Policy premiums for representation and warranty insurance have been steadily declining

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in recent years and now may range between 2.5–4% of the policy limit. The retention amounts required under these policies have similarly declined. It is now common to see this figure as low as 1% of enterprise value.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

It is advisable for private equity investors to build restrictions on the scope of representations and warranties that fund investors are required to give on a sale transaction. Representations and covenants as to the portfolio company's operations are more properly given by management shareholders who will have in-depth knowledge in this regard. Private equity investors required to indemnify a purchaser in respect of a breach should do so on a several basis and limitations should be placed on the dollar amount for which private equity investors are responsible. Typically, post-closing indemnification on the sale lasts 12−18 months (with fundamental representations and warranties lasting longer) and negotiated indemnity cap (for non-fundamental representations) often in the range of 5–30% of the sale price. Involvement of foreign participants, especially U.S.-based participants, is often correlated to the lower end of these ranges applying, whereas we see the upper ends of the ranges more commonly on truly domestic Canadian transactions.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

While representation and warranty insurance is becoming more popular, the traditional approach of a seller indemnity coupled with a purchase price holdback or escrow is also still common for both private equity buyers and sellers in Canada. In the event of an earn-out provision, set-off rights against the earn-out payment are also typical.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Private equity transactions typically involve equity financing from the private equity investor and debt financing from a third-party lender. Comfort, with respect to the equity financing, is often provided in the acquisition agreement which generally contains a commitment for the private equity investor to fund and complete the acquisition upon the satisfaction of certain conditions. The acquisition agreement generally also contains a representation and warranty that the private equity investor has sufficient funds to provide the funding. Comfort letters from the third-party lender or bank are typically tabled to provide comfort with respect to the debt financing.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are becoming more common in Canadian private equity transactions. These fees are typically negotiated as a fixed dollar amount or a percentage of enterprise value. Due to the increased exposure of the target entity to potential damage from a failed deal, reverse break fees are often higher than the negotiated break fee on a transaction, ranging up to 10% of enterprise value.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

Generally seen as the gold standard, ideal exit for a private equity seller, IPO activity continued to grow in 2018 but is still not a common form of exit. When considering an IPO exit, private equity sellers should be aware of the costs of preparing for and marketing the IPO, which includes the preparation of a prospectus and a road show. It is also important for the private equity seller to be aware that an IPO will not allow for an immediate exit of its entire position and that the private equity's final exit will be subject to lock-up provisions which will limit the investor's abilities to sell their shares for a period of time following the IPO.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

Underwriters in an IPO will require these shareholders to enter into a lock-up agreement as a condition to the underwriting to ensure their shares do not enter the public market too soon after the IPO. While the terms of lock-up agreements are subject to negotiation, they typically last 180 days.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Until recently, dual-track processes have not been the norm in Canada. However, given current market conditions and the recent increase of these processes in the United States, we expect to see them becoming more common in Canada as well. Following several dual-track processes being utilised in 2018, we anticipate the trend continuing in 2019 as buyers seek ways to hedge the risk of a failed attempt to go public while at the same time as increasing valuations.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Foreign investors, largely U.S.-based, account for a substantial portion of private equity investment in Canada. U.S. investors often bring their American debt financing with them or obtain Canadian debt financing. Private equity investors utilising U.S. debt sources for Canadian private equity transactions need to develop FX hedging strategies, which are typically only provided by traditional banks and can be costly.

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Traditional senior secured debt obtained from a domestic Canadian bank, often in the form of a revolving credit facility or term loan, remains the most common source of debt financing in Canadian private equity transactions. Senior secured debt will also at times be supplemented by mezzanine financing (usually by way of subordinated debt) through banks or other financial institutions.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

There are no relevant legal requirements or restrictions that impact the choice of structure used for debt financing in Canadian private equity transactions.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

Most private equity firms currently use private lending as part of the financing for their Canadian transactions and many firms intend to increase their reliance on this type of financing through 2019.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Many of the common tax considerations in transactions with private equity funds apply equally to transactions with strategic buyers. However, there are several considerations that may take on added importance when transacting with foreign private equity investors in particular.

Dividend payments made by Canadian portfolio companies to foreign private equity investors are generally subject to a 25% withholding tax, although this rate is substantially reduced under tax treaties in most instances.

Non-resident investors should also familiarise themselves with Canada's thin-cap rules that prohibit Canadian companies from deducting interest on a portion of interest-bearing loans from specified non-residents that exceed one-and-a-half times the tax equity of the "specified non-residents" in the Canadian company.

Historically, intermediary entities in tax-favourable jurisdictions such as Luxembourg and the Netherlands have often been utilised by foreign-based private equity funds investing into Canada. However, the Organisation for Economic Cooperation and Development's Base Erosion and Profit Shifting ("BEPS") initiative have significantly impacted the usage of such intermediaries.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Stock options remain the most popular stock-based compensation tool, due to their favourable treatment (no taxation until exercise and general eligibility for a capital-gains equivalent rate of tax). Other popular stock-based compensation arrangements for management include stock appreciation rights and deferred stock units.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

Investors in a Canadian company are generally permitted a tax-free rollover when exchanging their shares in the company for shares of another Canadian company, but not when such shares are exchanged for shares of a non-Canadian company. An effective workaround may be available in the latter circumstances through the use of "exchangeable shares" (i.e., shares of a Canadian company that are exchangeable for, and are economically equivalent in all material respects with, shares in the relevant foreign company).

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

As noted above, the Organisation for Economic Cooperation and Development's BEPS initiative, insofar as anti-treaty-shopping measures are concerned, has significantly decreased foreign-based private equity funds' usage of intermediary entities in favourable jurisdictions (such as Luxembourg and the Netherlands) for their Canadian investments.

Amendments to the *Excise Tax Act* (Canada), enacted as of October 25, 2018 impose goods and services tax obligations on investment limited partnerships. These changes impose goods and services tax on management and administrative services provided by the general partner of an investment limited partnership. If the partnership meets the definition of "investment limited partnership", the general partner will be obligated to charge and remit goods and services tax on the fair market value of any management/administrative services provided.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

Recent amendments to the *Competition Act* (Canada) have expanded what is considered "an affiliate" for the purposes of applying the *Competition Act* thresholds. As amended, the *Competition Act* now includes non-corporate entities as affiliates. Under these amendments, funds structured as partnerships will now be considered affiliates of both portfolio companies under their control and any other similarly structured sister funds controlled by the same entity. This increases the number of entities that may count towards the "size of the parties" threshold and is expected to result in a greater number of private equity transactions triggering the notice requirements.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

Private equity investors are not subject to specific regulatory scrutiny; however, as noted above, recent amendments to the *Competition Act* are likely to increase the number of private equity transactions that trigger advance notice requirements under the *Competition Act*.

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Foreign investments that constitute an acquisition of "control" of a Canadian business will require approval under the *Investment Canada Act* if the investment exceeds certain monetary thresholds, involves a cultural business, or has national security implications. Such investments are subject to approval by the federal Ministry of Innovation, Science and Economic Development or the Minister of Canadian Heritage depending on the nature of the Canadian business being acquired.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

The majority of private equity investors conduct thorough legal due diligence, reviewing all material legal documents including the target entity's corporate records, materials contracts and employment records. In addition, publicly available searches are also typically conducted in order to identify any registered encumbrances, active legislation, bankruptcy filings and other similar matters. Most legal due diligence is conducted by external counsel and other professionals, such as environmental consultants. The length of the diligence review and materiality threshold applied differs greatly and is often dependent on the nature of the sale process, the risk tolerance of the private equity investor and the industry the target is in.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Canada's *Corruption of Foreign Public Officials Act* ("CFPOA") was enacted in 1998 to ensure commercial fair dealing, government integrity and accountability, and the efficient and equitable distribution of limited economic resources. CFPOA prohibits the promise, payment or giving of money or anything of value to any foreign official for the purpose of obtaining or retaining business or gaining an improper advantage and concealing bribery in an entity's books and records. Private equity transactions, especially in sensitive industries or which involve a target with material government contracts, typically specify diligence contracts as well as corporate records and policies for compliance with this legislation. In addition, representations and warranties are often obtained from the seller confirming the entity's compliance with the same.

While the *Foreign Corrupt Practices Act* ("FCPA") is an American law, U.S. private equity investors often seek assurances that Canadian target entities are complying with FCPA. If the Canadian target is not currently owned by an American interest, this can be problematic.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Typically, Canadian courts are hesitant to pierce the corporate veil and hold shareholders liable for their portfolio companies. However, Canadian courts will pierce the corporate veil where a corporate entity is controlled and used for fraudulent or improper conduct. Likewise, to the extent a shareholder usurps the discretion of a director to manage the business, that shareholder will expose itself to the liabilities of a director of the entity.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Other factors which commonly raise concerns for private equity investors, especially foreign investors, include: that foreign ownership in specified industries such as financial services, broadcasting and telecommunications is limited by certain federal statutes; management and administration fees paid by a Canadian resident to a non-arm's length non-resident are subject to a 25% withholding tax; and that Canadian employment laws differ fairly significantly from American laws and impose more obligations and potential liabilities on a target corporation.

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Cayman Islands

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

The Cayman Islands is a popular jurisdiction in which to domicile private equity funds in light of its legislative and regulatory framework, tax-neutral status, flexible structuring options and experienced service providers.

While private equity fund establishment for acquisition purposes and co-investment opportunities are most common, Cayman Islands structures are becoming increasingly common in transactional contexts, particularly buy-out and secondary transactions.

The nature, scope and volume of matters being undertaken in the Cayman Islands across the entire funds market spectrum makes it difficult to identify one specific change or trend. Ultimately, there are many but they are all linked together by a singular overarching theme; the nature of offshore practice has become more complex, involved and multi-jurisdictional due to onshore and global developments; including US tax reform, more complicated and, at times conflicting, regulatory frameworks, bespoke structures and a mature funds industry. This will be documented in an appropriate manner in the governing documents adopted for Cayman Islands-domiciled vehicles, which will reflect the nature and terms of the underlying private equity transaction.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

The Cayman Islands continues to be the leading offshore domicile for private equity funds due to the global distribution appeal of Cayman Islands vehicles, their ease of use, speed to market and low cost. The Cayman Islands' tax-neutral status ensures the fund vehicle itself does not create an additional layer of tax, creating efficiencies in raising funds from a potentially global investor base.

The Cayman Islands is a well-regulated, co-operative and transparent jurisdiction and continues to refine its laws and regulatory standards to respond and adapt to international standards. This has been most recently demonstrated by the update to primary legislation governing the most popular entity types; notably exempted companies, exempted limited partnerships and limited liability companies. The Cayman Islands has also enacted legislation for a limited liability partnership vehicle.

The global regulatory framework is evolving quickly and this is likely to continue in the near-/mid-term future. The Cayman Islands continues to adopt and embrace international best practice approaches in multiple spheres which interact with private equity, including, by way of example, the regime for anti-money laundering and combatting terrorist financing, economic substance initiatives and tax transparency reporting obligations.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

Fund raising activity remains at strong levels and we expect this to continue in the near term. Equally, dry powder levels are also high. We expect deal activity to remain strong over the next 12 months as capital is deployed. The legal, regulatory and tax environment in the Cayman Islands remains favourable for structuring of both the raising of private equity funds and for downstream cross-border deal activity in the longer term.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

While a Cayman Islands private equity fund can also be structured as an exempted company, limited liability company or a trust, the majority of Cayman Islands private equity funds are established as limited partnerships.

The Cayman Islands fund vehicle will generally invest via other Cayman Islands vehicles, including aggregator, or entities domiciled outside the Cayman Islands, such as in Luxembourg or Ireland, depending on where the ultimate operating portfolio company or target entity is located. Ultimately, net returns from the underlying company or target will be distributed to the Cayman Islands domiciled fund vehicle, which net returns will be in turn distributed to investors and sponsors and be taxable in accordance with the regimes of the jurisdictions where such investors and sponsors are tax resident.

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2.2 What are the main drivers for these acquisition structures?

These structures combine the investor familiarity, sophistication and flexibility of Cayman Islands fund vehicles with the economic and structuring advantages of an underlying holding structure, which satisfies onshore tax and regulatory considerations in an efficient and streamlined manner.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

As the majority of Cayman Islands private equity funds are structured as exempted limited partnerships, investors subscribe for an equity interest in the exempted limited partnership in the form of a limited partnership interest. A sponsor/management will typically participate in the performance of the exempted limited partnership as a carry participant either directly as a partner or through a separate vehicle.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Minority investor protections, such as anti-dilution, veto or information rights, which transaction parties agree to accommodate within a structure can be reflected in the governing documents of any Cayman Islands vehicle. These matters are dictated by commercial, rather than Cayman Islands legal, considerations.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

There can be a broad range of approaches as to how profits and other returns are shared among a management team. This is generally left to the management team to determine with a sponsor and will reflect what is most appropriate with reference to their commercial arrangements and target returns.

The vast majority of Cayman Islands private equity funds are managed by a US or other international domiciled and regulated investment manager. Therefore, vesting and compulsory acquisition provisions relating to the management equity and restraints are typically driven by the onshore legal and regulatory considerations of the fund manager.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Good and bad leaver provisions, and vesting mechanics more generally, are structured in a wide variety of ways depending on the intention of the transaction parties. These matters are dictated by commercial agreement rather than Cayman Islands legal considerations or restrictions.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

A Cayman Islands private equity portfolio company can be formed as an exempted company, a limited liability company or a limited partnership.

For an exempted company, the board of directors is responsible for the overall management and control of the company. The composition of the board of directors of a portfolio company tends to vary depending on the nature of the private equity transaction. A director of an exempted company is in a fiduciary relationship to the company and owes various duties of a fiduciary nature, which may be broadly characterised as duties of loyalty, honesty and good faith. Every director owes these duties individually and they are owed to the company as a whole. Specifically, they are not owed to other companies with which the company is associated, to the directors or to individual shareholders. In addition to the fiduciary duties, each director owes a duty of care, diligence and skill to the company. The Register of Directors and Officers of an exempted company is not publicly available in the Cayman Islands.

A limited liability company can be member-managed or can appoint a separate board of managers. There is significant flexibility as to governance arrangements with respect to a limited liability company, which can be agreed by the parties in the limited liability company agreement. The default duty of care for a manager or managing member is to act in good faith. This standard of care may be expanded or restricted (but not eliminated) by the express provisions of the limited liability company agreement.

An exempted limited partnership is managed by its general partner. The general partner has a duty to act in good faith and, subject to the express provisions of the limited partnership agreement, in the interests of the partnership.

The Cayman Islands protects privacy of commercial arrangements and generally information will only need to be disclosed with consent or in other limited circumstances with law enforcement agencies or regulatory and tax authorities upon legitimate lawful and proper request.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

This is generally a case-by-case consideration based on the commercial circumstances of each transaction.

Investors in a Cayman Islands private equity fund do not typically enjoy veto rights over major corporate actions. For funds structures structured as exempted limited partnerships, the general partner must act within any limitations agreed in the limited partnership agreement of the fund (for example, as to business purpose, limitations on investment, limitations on indebtedness and guarantees, etc.). A limited partner advisory committee will often be established to approve any conflict transactions of the general partner or fund manager. A minority investor would not typically enjoy any veto rights.

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At an operating company level, it is very common for transaction parties to agree that certain matters will be reserved to shareholders acting by requisite thresholds, which may include veto rights or various minority protections, or require enhanced director approvals. These arrangements would be reflected in the company's governing documents, which would almost include a shareholders' agreement.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

There is no limitation on reflecting veto arrangements in governing documents although it requires a case-by-case analysis to determine how such arrangements should be accommodated most effectively in a specific context.

If structured as an exempted company, certain veto arrangements may be better afforded to shareholders as opposed to director nominees in light of the fiduciary duties owed by directors. There is greater flexibility where a limited liability company is employed. Such vehicles, by way of example, are particularly well-suited to joint ventures given the governing documents may authorise a manager to act in the interests of his/her appointing member.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or vice versa)? If so, how are these typically addressed?

As a matter of Cayman Islands law, a private equity investor does not generally owe fiduciary duties or any other duties to minority shareholders (or *vice versa*), unless duties of this nature have been contractually agreed between the parties and/or are otherwise expressly set out in governing documents.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

A shareholders' agreement governed by the laws of another jurisdiction (other than the Cayman Islands) is generally enforceable in the Cayman Islands (provided that the agreement is not contrary to Cayman Islands law or public policy). With respect to non-compete and non-solicit provisions, such provisions in restraint of trade are presumed to be unenforceable under Cayman Islands law. That presumption can, however, be rebutted by proving that the restraint is "reasonable", both as between the parties and in relation to the public interest, particularly with reference to time and geographical scope.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

While there are no Cayman Islands statutory restrictions preventing a private equity investor from appointing a nominee to the board of a Cayman Islands portfolio company, any such director owes fiduciary and other duties to the company as a whole and not to the private equity investor that nominated the director to the board. Consequently, any such nominee director must be mindful to avoid a conflict between their duty to the company and their personal interests (or the interests of the private equity investor) and must at all times act in the best interests of the company. Should a director act in breach of its fiduciary and other duties owed to the company, it risks incurring personal liability. As noted previously, there can be greater flexibility in this regard if a Cayman Islands limited liability company is used as the portfolio company.

The concept of a "shadow director" is only recognised in limited circumstances in the context of certain offences in connection with winding up of a Cayman Islands company under the Companies Law (2018 Revision). In these circumstances, a private equity investor may be considered to be a shadow director if the nominee director is accustomed to acting in accordance with the directions or instructions of the private equity investor responsible for his or her appointment to the board.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Directors are required to comply with the conflicts of interest provisions set out in the articles of association of the relevant portfolio company. Typically, the articles of association of a Cayman Islands company permit a director to vote on a matter in which he or she has an interest, provided that he or she has disclosed the nature of this interest to the board at the earliest opportunity. If a director may wish to recuse himself/herself from a vote on such a matter, then the articles of association should be sufficiently flexible to enable a majority of directors at an otherwise quorate meeting to proceed with a vote.

Where private equity funds are structured as limited partnerships, a limited partner advisory committee or other independent committee will often be established to approve any conflict transactions.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

The timetable for transactions is driven by onshore issues, such as regulatory approvals required in the jurisdictions where the assets are domiciled or where the private equity investors are resident.

There are no competition approvals or regulatory approvals required for Cayman Islands private equity structures notwithstanding that certain filings or notifications may need to be made contemporaneously with, or subsequent to, a deal's completion.

4.2 Have there been any discernible trends in transaction terms over recent years?

The trends that develop in the Cayman Islands in the context of private equity funds and transactions reflect the trends experienced or developed in the US, Europe, Asia and other markets as well as broader evolving regulatory trends and globally adopted best practices.

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The flexibility of Cayman Islands law allows transacting parties to replicate or accommodate deal terms driven by onshore requirements.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Generally, the target companies in public-to-private transactions are not based in the Cayman Islands. The applicable considerations to take into account would be determined with reference to the laws and regulations of the jurisdiction where the target company is based.

Where the target company is a Cayman Islands company, then the target would almost certainly be listed on a stock exchange outside the Cayman Islands. The listing rules of such non-Cayman Islands stock exchange would apply.

If, however, the target company were listed on the Cayman Islands Stock Exchange (**"CSX"**), then the Cayman Islands Code on Takeovers and Mergers and Rules Governing the Substantial Acquisitions of Shares would apply (the **"Code"**), which Code is administered by a council executive appointed by the Stock Exchange Authority, the CSX's regulator.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

As previously noted, the target companies in public-to-private transactions are generally not based in the Cayman Islands. In those instances, the considerations that would apply are driven by laws in the relevant jurisdiction(s) where the target is based and/or the rules of the non-Cayman Islands stock exchange on which its shares are listed.

In the case of a CSX-listed entity, the Code contains a number of protections for minority shareholders. These include: mandatory offer rules; an obligation to offer a minimum level of consideration; acquisitions resulting in a minimum level of consideration; and rules against offering favourable conditions except with the consent of the council executive.

More generally, as a matter of Cayman Islands law there may be other protections available to investors, the nature of which protections will depend on the manner in which the deal is structured. By way of example, if the private equity investors were shareholders in a Cayman Islands-exempted company and the public acquisition were structured by way of a merger, then such investors may be able to avail themselves of dissenting shareholder rights and apply to the Courts seeking fair value for their shares.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

The operating companies and deal terms for specific portfolio investments are generally not governed by Cayman Islands law and are non-Cayman Islands considerations typically driven by onshore tax and regulatory considerations.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

The operating companies and deal terms for specific portfolio investments are generally not governed by Cayman Islands law and are non-Cayman Islands considerations typically driven by onshore tax and regulatory considerations.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

The operating companies and deal terms for specific portfolio investments are generally not governed by Cayman Islands law and are non-Cayman Islands considerations typically driven by onshore tax and regulatory considerations.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

The operating companies and deal terms for specific portfolio investments are generally not governed by Cayman Islands law and are non-Cayman Islands considerations typically driven by onshore tax and regulatory considerations.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

The operating companies and deal terms for specific portfolio investments are generally not governed by Cayman Islands law and are non-Cayman Islands considerations typically driven by onshore tax and regulatory considerations.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

The operating companies and deal terms for specific portfolio investments are generally not governed by Cayman Islands law and are non-Cayman Islands considerations typically driven by onshore tax and regulatory considerations.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

The deal terms for specific portfolio investments are generally not governed by Cayman Islands law, nor driven by Cayman Islands considerations. As such, the comfort provided and sellers' enforcement rights with respect to financing commitments reflect commercially agreed terms and are typically negotiated and agreed by onshore deal counsel.

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6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

The operating companies and deal terms for specific portfolio investments are generally not governed by Cayman Islands law and are non-Cayman Islands considerations typically driven by onshore tax and regulatory considerations.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

This will depend primarily on which exchange the IPO is listed; usually, the Cayman Islands Stock Exchange will not be the primary listing for such transactions.

Note that any listing vehicle will need to be a Cayman Islands-exempt or ordinary company. Limited partner interests in a limited partnership and membership interests in a limited liability company cannot themselves be the subject of an IPO. It is also not possible to convert a Cayman Islands limited partnership into a company. Therefore, care should be taken to include sufficient flexibility in the documents on acquisition to ensure we have the correct type of entity for listing on an IPO exit.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

This will depend primarily on which exchange the IPO is listed; usually the Cayman Islands Stock Exchange will not be the primary listing for such transactions.

Typically, these commercial terms are agreed by onshore counsel to the IPO.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

This will depend primarily on which exchange the IPO is listed; usually the Cayman Islands Stock Exchange will not be the primary listing for such transactions.

We often see private equity sellers pursuing a dual-track exit process. The dual track can run very late in the process. In recent times we have seen more dual-track deals ultimately realised through sale.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

The Cayman Islands is a leading "creditor-friendly" jurisdiction where both Cayman Islands and non-Cayman Islands security packages are respected and recognised. Financing counterparties are very familiar with, and comfortable lending to, Cayman Islands vehicles, which are able to access the full range of debt finance options seen in the market. Common private equity financing structures include subscription line facilities secured on investors' capital commitments, and leveraged finance facilities secured by the relevant target group's assets.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

There are no specific Cayman Islands statutory restrictions impacting the type of debt financing activity that can be undertaken and Cayman Islands vehicles are generally able to access the full range of debt finance options seen in the market. Restrictions on debt financing may, however, be contained in the constitutional documents of the Cayman Islands vehicle (such as a limited partnership agreement in the case of a partnership), the terms of which would be agreed by the sponsor and investors on launch of the fund.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

There has been a continuation of the use of all subscription and bridge facilities across the private equity market with a marked increase in financings involving the use of wholly owned investment companies incorporated in the Cayman Islands. The vehicles are structured as bankruptcy-remote with at least one independent director or manager, as the case may be, appointed to the board. This satisfies the lender's bankruptcy concerns and provides strong credit protection for the secured parties. These financings include plain vanilla loans, note issuances and also various derivative transactions including total return swaps and repurchase structures.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

The Government of the Cayman Islands does not, under existing legislation, impose any income, corporate or capital gains tax, estate duty, inheritance tax, gift tax or withholding tax upon (i) Cayman Islands-exempted companies, exempted trusts, limited liability companies or exempted limited partnerships established to operate as private equity funds or portfolio vehicles, or (ii) the holders of shares, units, LLC interests or limited partnership interests (as the case may be) in such private equity vehicles. Interest, dividends and gains payable to such private equity vehicles and all distributions by the private equity vehicles to the holders of shares, units, LLC interests or limited partnership interests (as the case may be) will be received free of any Cayman Islands income or withholding taxes.

An exempted company, an exempted trust, limited liability company or an exempted limited partnership may apply for, and expect to receive, an undertaking from the Financial Secretary of the Cayman Islands to the effect that, for a period of 20 years (in the case of an exempted company) or a period of 50 years (in the case of a limited liability company, an exempted trust or an exempted limited partnership) from the date of the undertaking, no law which is enacted in the Cayman Islands imposing any tax to be levied on

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profits or income or gains or appreciations shall apply to the vehicle or to any member, shareholder, unitholder or limited partner (as the case may be) thereof in respect of the operations or assets of the vehicle or the interest of a member, shareholder, unitholder or limited partner (as the case may be) therein; and may further provide that any such taxes or any tax in the nature of estate duty or inheritance tax shall not be payable in respect of the obligations of the vehicle or the interests of a member, shareholder, unitholder or limited partner (as the case may be) therein.

The Cayman Islands are not party to a double tax treaty with any country that is applicable to any payments made to or by private equity vehicles.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

As the Cayman Islands is a tax-neutral jurisdiction, these arrangements are typically driven by the tax laws of the jurisdictions where the management team is located. However, Cayman Islands law allows for significant scope and flexibility to structure management equity programmes in a wide variety of ways.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

As the Cayman Islands is a tax-neutral jurisdiction, these arrangements are typically driven by the tax laws of the jurisdictions where the management team is located.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

The Cayman Islands has signed an inter-governmental agreement to improve international tax compliance and the exchange of information with the United States (the "**US IGA**"). The Cayman Islands has also signed, along with over 80 other countries, a multilateral competent authority agreement to implement the OECD Standard for Automatic Exchange of Financial Account Information – Common Reporting Standard ("**CRS**" and together with the US IGA, "**AEOI**").

Cayman Islands regulations have been issued to give effect to the US IGA and CRS (collectively, the "**AEOI Regulations**"). All Cayman Islands "Financial Institutions" (as defined in the relevant AEOI Regulations) are required to comply with the registration, due diligence and reporting requirements of the AEOI Regulations, unless they are able to rely on an exemption.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

The Cayman Islands continues to refine its laws and regulatory framework to ensure that it meets the ever-increasing demands of the private equity industry. This ability to respond and adapt has resulted in the following legal developments over recent years:

- On 27 December 2018, the Cayman Islands published The International Tax Co-operation (Economic Substance) Law, 2018 as a response to global OECD Base Erosion and Profit Shifting ("**BEPS**") standards regarding geographically mobile activities. Requirements of this type are rapidly being implemented on a level playing field basis by all OECD-compliant "no or only nominal tax" jurisdictions.
- The Cayman Islands was an early introducer of comprehensive and strict anti-money laundering laws and "know your client" rules and regulations and continues to adapt these rules and regulations in line with international standards. In a continuing effort to meet international standards, a comprehensive update was made to the Anti-money Laundering Regulations (2018 Revision) in October 2017.
- The enactment of the Limited Liability Companies Law in 2016 provided for the formation of a new Cayman Islands vehicle: the limited liability company. Since its introduction, we have seen LLCs used in private equity structures, particularly as GP governance vehicles, aggregator vehicles (where multiple related funds are investing in the same portfolio investment) and holding companies/blockers in portfolio acquisition structures.
- A comprehensive review and update to the Exempted Limited Partnership Law took place in 2014. While the new law did not make fundamental alterations to the nature, formation or operation of Exempted Limited Partnerships, it promotes freedom of contract and includes provisions to deal specifically with issues and concerns raised, and suggestions made, by the industry to bring the Exempted Limited Partnership Law even further into line with Delaware concepts.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

Generally speaking, private equity funds established in the Cayman Islands investing in business located outside the Cayman Islands are not subject to regulation by the Cayman Islands Monetary Authority ("**CIMA**") under the Cayman Islands Mutual Funds Law (2019 Revision).

A private equity transaction to acquire a business located in or regulated in the Cayman Islands such as a local bank, insurance company or utility services provider may be subject to scrutiny by CIMA and the Cayman Islands Trade and Business Licensing Board.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)? Do private equity investors engage outside counsel / professionals to conduct all legal / compliance due diligence or is any conducted in-house?

The approach to legal due diligence depends on the particular sponsor and may also vary on a transaction-by-transaction basis.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

The Cayman Islands' Anti-Corruption Law (2019 Revision) (the

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"**AC Law**") came into force on 1 January 2010 with the intent of giving effect to the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, as well as the United Nations Convention Against Corruption. The AC Law replaced the provisions relating to anti-corruption and bribery which previously existed under the Penal Code, and provides generally for four categories of corruption offences: Bribery (both domestic and foreign); Fraud on the Government; Abuses of Public or Elected Office; and Secret Commissions. There are also ancillary offences for failure to report an offence. The impact of the AC Law on private equity transactions in the Cayman Islands, given the sophistication of the parties involved and the nature and quality of their transactions, has been minimal, although more commonly transaction documents now include a warranty relating to compliance with such laws.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

As a general rule, in the absence of a contractual arrangement to the contrary, the liability of a shareholder of a Cayman Islands-exempt company which has been incorporated with limited liability and with a share capital is limited to the amount from time to time unpaid in respect of the shares he or she holds. A Cayman Islands company has a legal personality separate from that of its shareholders and is separately liable for its own debts due to third parties. Accordingly, a company's liability does not generally pass through to its shareholders.

The general principles regarding corporate personality under Cayman Islands law are similar to those established under English law, and a Cayman Islands Court will regard English judicial authorities as persuasive (but not technically binding). Accordingly, from the date of incorporation of a Cayman Islands company, it is a body corporate with separate legal personality capable of exercising all the functions of a natural person of full capacity. This includes the ability to own assets, and perform obligations, in its own name as a separate legal person distinct from its shareholders (*Salomon v. Salomon & Co.* [1897] A.C. 22).

As a matter of English common law it is only in exceptional circumstances that the principle of the separate legal personality of a company can be ignored such that the Court will "pierce the corporate veil". These circumstances are true exceptions to the rule in *Salomon v. Salomon*, and there is now a well-established principle under English law that the Court may be justified in piercing the corporate veil if a company's separate legal personality is being abused for the purpose of some relevant wrongdoing.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Cayman Islands private equity vehicles play a well-established and growing role in private equity fund structures. This role is evidenced by the growing number of exempted limited partnership registrations in the Cayman Islands. Statistics issued by the Registrar of Partnerships have confirmed that in the years since the 2008 financial crisis, the Cayman Islands has seen a consistent increase in the number of annual partnership registrations. In 2018, the number of active exempted limited partnerships stood at 26,011, compared with 22,346 in 2017 and 19,937 in 2016. This continued rise in the popularity of Cayman Islands private equity structures can be attributed in part to the Cayman Islands' commercial and industry-specific laws, transparency initiatives and compliance with international standards, coupled with the Cayman Islands' flexibility to implement change and adapt to new opportunities and challenges.

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China

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

PE transactions in China include both growth capital investments and buyout transactions. One unique aspect worth mentioning is the fact that transactions, depending on the future exit, may be structured as an onshore transaction or offshore transaction. If the future exit is likely to be an IPO in a non-PRC stock market (e.g., a stock exchange in the US or Hong Kong), then the listing vehicle will likely take the form of a company incorporated in an offshore jurisdiction such as the Cayman Islands (i.e., an offshore holding company). With such plan in mind, the PE investors will invest into such offshore holding company and exit after the IPO of such offshore vehicle. If the target company is a PRC domestic entity, then the PE investors would often require that a company restructuring be completed as a closing condition, such that the PE investors will become the shareholders of the offshore holding company.

In contrast, if the target company is to be listed within the PRC on one of the domestic stock exchanges, then the listing vehicle must be a PRC incorporated joint stock company. PE investors will invest into such domestic company which is governed by the PRC law, including company law, securities rules and, if applicable, regulations on foreign investment in China.

The market used to be dominated by growth capital-style investments where the PE investors tend to hold minority stakes; however, there has been an increase in the popularity and number of buyout transactions in China thanks to a variety of factors, including increased competition among investors who are chasing fewer growth capital deals, the emergence of privatisation deals, the government's regulatory liberalisation allowing loans (subject to conditions and limitations) to finance M&A and buyout transactions, and the increasing willingness of founding shareholders of companies, while reaching retirement age, to sell controlling stakes to third-party buyers, such as buyout funds.

For regular transactions, club deals may not be as prevalent; especially when each of the PE investors faces deal-sourcing pressure and intends to keep the deals to themselves as long as the investment size is within their own pricing range. While for larger transactions, including privatisation deals, those funded partly by debt financing, or those requiring certain special expertise or value offered by one or more of the "club members", club deals can be appealing. Also, in the context of a buyout, investors also have to consider factors such as who gets to have control of the target and may as well then rule against club deals as an option.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Since the Ministry of Commerce (MOFCOM) promulgated the Provisions on Foreign Investors Acquiring Domestic Enterprises (Circular 10) back in 2006 (as amended in 2009), it has become difficult to convert an onshore domestic PRC company structure into an offshore structure, making it difficult for the foreign PE investors to opt for the option of establishing an offshore structure for investment and future exit through an overseas IPO. Founders of domestic companies will have to rely on experienced counsels to go through sophisticated, and often costly, restructuring processes to migrate the domestic structure into an offshore one. If this is not successful, then the foreign investors will have to invest directly into the PRC domestic target, resulting in a Sino-foreign joint venture, which, after converting into a joint stock company (a.k.a. a company limited by shares), may be considered for listing in one of the PRC stock exchanges (i.e., an "onshore IPO or listing" in China). It should be noted that IPOs in China are subject to review and approval by the China Securities Regulatory Commission (CSRC) and the process usually takes many months and even years, and companies often have to wait in a long queue for such approval. As a result, despite the fact that the PRC stock markets sometimes can offer higher PE ratios for companies listed on the A-share stock exchanges, the longer waiting period does create more uncertainty than those overseas stock exchanges.

The issue of the long waiting period for domestic IPO approval may now be eased with the introduction of the new "Science and Technology Innovation Board (STIB or Sci-tech innovation board)", in March 2019 at the Shanghai Stock Exchange. With the newly adopted registration-based listing system, the conventional CSRC approval-based IPO regime will be replaced with a filing and registration regime for the purpose of listing at STIB, which would significantly speed up the process which could otherwise be months and years for going through the approval and review process. STIB will especially give priority to companies in high-tech and strategically emerging sectors such as new generation information technology, advanced equipment, new energy, new materials and biomedicine. The new policies and regulations reflect the government's intent to fuel growth and development for tech

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companies, which is also encouraging for PE and VC investors for such added new exit channel.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

In March 2019, with the introduction of the Foreign Investment Law of the PRC (the "Foreign Investment Law") (which will come into effect on January 1, 2020), the three existing specific laws on sino-foreign equity joint ventures, wholly foreign-owned enterprises and sino-foreign co-operative joint ventures will be superseded after a five-year transition period.

Furthermore, the new law provides that except for those sectors specified in the "Negative List" for foreign investment where approvals are still required by MOFCOM, normal FIEs can be established without approval but with a filing procedure. Compared with the 2017 Negative List, the updated list in 2018 has removed foreign ownership restrictions in more industrial sectors, such as banking, gas station construction and operation, aero craft manufacturing and new energy auto making.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

There are onshore and offshore structures available for PE transactions. Under the onshore investment model, the PE fund, through an offshore special purpose vehicle (SPV), invests into the onshore PRC domestic corporate entity directly and becomes a shareholder of the onshore company.

Under the offshore investment model, the PE investor or its SPV invests into or acquires shares of the offshore holding company of the target company, and such offshore holding company often holds 100% interests in a HK intermediary company, which then holds 100% interests in a subsidiary in the PRC, in the form of a "wholly foreign owned enterprise" (WFOE). Such offshore holding company is most often intended to become a listing vehicle in the future overseas IPO and, due to the nature that it holds assets directly or indirectly in China, such offshore holding company is often referred to as a "red chip" company.

2.2 What are the main drivers for these acquisition structures?

PE investors often set up one or more SPVs and use the SPVs to hold interests in the target company. The drivers for such acquisition structure can be related to tax planning and avoidance of onshore PRC approval in case of share transfer. If the equity transfer involves the equity interests or shares of a PRC company, government approval is required if there is any involvement of foreign investment. Although such approval is not hard to get and has largely become a formality, it does usually take 20 working days for the approval authority to process and then grant the approval. So, if there is an offshore intermediary company (such as the HK company), the PE investor can simply sell or transfer the HK company to a buyer bypassing the onshore approval, while still achieving the same result of exiting.

As to tax, in light of the rules issued by PRC State Administration of Tax (SAT) including Bulletin 7, offshore changing-hands of equity interests or shares that indirectly sell or transfer the onshore company could be subject to PRC tax filing and potential taxes as if the parties made such sale or transfer onshore. In light of this development, the PRC tax benefits of setting up such offshore SPVs as intermediary companies have now become limited.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

Both "sweet" equity and management reinvestment into the institutional strip have been seen in PE transactions in China. For the sweet equity shares, they are normally issued to the management teams at a lower price to provide extra incentive for the management, subject to restrictions, or at the same price as the PE investor with the same class of share rights with such investor. Carried interest arrangement is often structured as an earn-out or ratchet adjustment. In certain deals, carried interest can also be structured as a part of the consideration for the management's subscription of additional shares.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Normally, if a PE investor acts as a minority shareholder, it will require protective provisions in the governance documents of the target, e.g., the shareholders agreement and Articles of Association of the target. Meanwhile, the investor might also insist on special exit right terms, such as drag-along, redemption, etc. to ensure a proper exit.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

A typical vesting schedule usually links with the term of the employment, IPO timeline and other exit schedules. In usual cases, unvested shares will be subject to company repurchase at par value or nominal price if the management shareholder ceases employment or service with the company. Vested shares can also be subject to company repurchase if the management shareholder commits a default.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

In the event that a management equity holder leaves a company, depending on the contractual arrangement, the company may exercise a call option over his or her equity interests at an agreed price. The typical definition of "good leaver" would include the following circumstances, i.e., the death or incapacity of the owner or manager, or sometimes resignation or retirement on good terms. If a manager commits breach of contract, fraud, wilful misconduct, or engages in other unethical activities, he may be deemed as a "bad leaver". But those often are subject to the contract terms and negotiation between the parties.

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3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

There are several mechanisms to ensure proper governance arrangements with the portfolio companies in PE investments. First, in respect of the board of directors, usually the PE investor, regardless of its minority stake in the portfolio company, would request a director seat on the board, which has veto rights over a host of material matters relating to the management and operations of the company. If there is a holding company structure involving multiple tiers of corporate entities, then such PE-appointed director will appear on the board of each of the entities. In other words, if the PE fund invests in the offshore holding company level, which owns 100% of the onshore operating subsidiary (i.e., WFOE), then the dual board structures will normally be put in place with mirrored board members.

Second, if the PE investor only invests a minority stake in the portfolio company, it is advisable for the PE investor to install an operation VP and/or a financial controller in the founder-controlled operating company, so that it can monitor the operations and company expenditures and control any spending in excess of any agreed amount.

Third, it is worth mentioning that under the PRC law and practice, usually it is the legal representative of the onshore operating company (e.g., the WFOE) that has the power to sign documents binding on the company. Such legal representative role is normally assumed by the chairman of the board, usually the founding shareholder of the portfolio company. For convenience, such legal representative also holds the company chop/stamp. Under the PRC law, any documents that bear the company chop are binding on the company even if such documents do not have any signatures from the legal representative or other authorised representative of the company. With the company chop, anyone can go to the bank to change the authorised signatory for releasing funds from the company's accounts. Thus, caution suggests designing a proper mechanism to jointly-control the company chop or otherwise formulate a chop-use protocol for the portfolio companies.

If such governance arrangements of portfolio companies are reflected in their Articles of Association, given that constitutional document is always required to be filed with the government authority, such governance arrangements will be publicly available.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Yes. There is usually an extensive list of reserved matters negotiated between the PE investors and the controlling shareholder(s) of the portfolio company. The reserved matters will be subject to the veto right of the PE investor(s), which typically include: any amendments to the Articles of Association; any change of the business scope, or the name of the company; any change of the company's capitalisation; signing any material contracts with value in excess of certain specified threshold(s); any matters relating to merger, split, IPO, change of legal form, liquidation or dissolution of the company; making loans to any parties; providing any security or guarantee to any parties; and any matters that may have any material impact on the company's management, operations or financial performance. As to a PE investor taking a minority position, it will at least enjoy, by statute, the following four veto rights as these decisions must be subject to a unanimous consent of all the directors present at the board meeting under the PRC law: any amendments to the Articles of Association; termination and dissolution of the company; increase or reduction of the registered capital of the company; and merger or division of the company. However, the PE investor would usually request a much longer list of reserved matters based on their negotiation with the controlling shareholder(s) of the portfolio company.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

If the shareholder meeting can reach resolution, bypassing the board, then the PE investor must make sure it has the veto power at both the board level and shareholder meeting level in respect of the particular reserved matter of its concern.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

This question seems to suggest the context where a PE investor acts as majority shareholder after a buyout transaction. If it is an onshore transaction, under the PRC law there are certain statutory provisions on minority shareholder's rights, including a super majority voting requirement, but there is no express provision specifying duties owed by a majority shareholder to a minority shareholder.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

If it is an onshore transaction where the foreign PE investor invests into or acquires equity interests in a PRC company, then the transaction will be subject to government approval. The share purchase agreement (or equity subscription agreement) along with the shareholders' agreement (or joint venture contract) must be governed by the PRC law.

If the transaction takes place offshore, then shareholder agreements are normally subject to the law of the jurisdiction of the offshore company (such as the Cayman Islands), while the share subscription agreement may be governed by a different law.

International arbitration is commonly selected over court adjudication for dispute resolution clauses in those agreements. Founding shareholders or sellers from China commonly request to choose a China-based arbitration tribunal, while the foreign PE investors tend to select international arbitration in venues like Hong Kong, Singapore, and London.

There is no express provision under the PRC law in respect of the limitations or restrictions on the contents or enforceability of shareholder agreements relating to non-compete and non-solicitation.

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3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

If the PE investor has a controlling stake or otherwise gets to appoint the chairman of the board of directors, and such chairman also acts as the legal representative of the company, the investor and the appointed person should be aware that, under the PRC law, the legal representative has certain obligations by default, such as appearing in court on behalf of the company, accommodating investigations activities undertaken by the government authorities relating to the company, and to the extent the company is unable to pay debt as required by court, the plaintiff can apply to the court to issue an order or injunctive relief to restrict such legal representative from leaving the country. Those are the practical risks a person acting as legal representative should be aware of, in particular when the company's operations are under control by another shareholder or someone that the PE investor cannot fully trust.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Under the PRC Company Law, none of the directors, controlling shareholders, members of the senior management and supervisors may use his or her relationships with the company to impair the interests of the latter. Specifically for listed companies, if a member of the board is "related to" (i.e., having interest in or conflicts of interest with) the subject matter to be voted in the proposed board meeting, then such board member must recuse himself or herself and shall not cast a vote on resolutions over this matter, and shall not act as proxy of any other directors either. As regards to the taking of a directorship position in another company, the law does not prohibit or restrict such act *per se*, but it should be cautiously noted that a director of a company, without prior consent of the company's shareholders' meeting or shareholders' assembly, may not engage in activities for, take positions at or work for any firms that may be competing with the business of such company.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

As mentioned above, all onshore transactions involving any foreign investors require MOFCOM or its local counterparts' approval and then registration with the local Administration for Industry and Commerce (AIC). For offshore transactions, such approvals will not normally be required, with exceptions such as merger filings for antitrust reasons and tax (Bulletin 7) filings.

In addition, when converting a PRC domestic structure into an offshore structure, if any of the shareholders of the offshore holding company (i.e., the future "ListCo.") are PRC residents, SAFE (Circular 37) registrations will be required. These regulatory procedures will normally delay the transaction process and could create uncertainty over closing if they are not managed properly in advance.

Cultural differences during communications and negotiations between Chinese and foreign parties can also be an important element that needs to be factored into for deal planning and project management purposes. For example, Chinese parties sometimes prefer more face-to-face meetings and real-time discussions of the terms and striking deals on principles rather than the nitty-gritty, while westerners tend to have the detailed terms and conditions laid out on paper, and expect more back-and-forth document mark-ups and exchange of negotiation points via email.

Different understanding of terms and having meanings lost in translation may also create misunderstandings and twists.

4.2 Have there been any discernible trends in transaction terms over recent years?

For both onshore and offshore transactions, PE firms have started to realise that sound deal structures and foolproof transaction terms must be carefully formulated in light of the unique business environment and legal infrastructure in China. In addition to extensive due diligence, earn-out mechanisms and management incentives are increasingly popular in PE transactions, with binding terms of founders (i.e., founders are committed not to exit until IPOs or a certain trigger event, e.g., acquisition by industrial players).

When crafting the deal terms, PE investors often have to focus on the roles and responsibilities of the founders and management and how to incentivise them as they can be a primary factor for determining the success of a particular portfolio company given the dynamic market situation in China. Also, given the increased competition among PE investors chasing for deals, founders tend to have more bargaining power in negotiating the valuation and other transaction terms.

Exits through listing in China or acquisition by a listed company in China are also becoming an emerging trend. IPOs through the Chinese stock market, and listing on National Equities Exchange and Quotations (NEEQ) are becoming increasingly appealing given the recent boom in the Chinese stock market, and the price/earnings ratios can be much higher than those available in the developed countries' stock markets. For specific terms and clauses, founder indemnity, targeted sales volume, and ratchet arrangement are commonly seen, while warranty and indemnity insurance and stapled financing are considered rare in the market.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

The commonly seen public-to-private transactions in the market are those overseas listed companies (such as those Chinese companies listed on stock exchanges in the US, Hong Kong, and Singapore) that are taken private with the help of PE investors with the intent to go public again at another stock exchange in the future, for better valuation and/or liquidity. The challenges include the requirements of the stock exchange and the uncertainty arising from the public shareholders. The PRC counsel also plays a significant role in, among others, restructuring the privatised company into an onshore domestic company suitable for A-share listing in the PRC, if the

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controlling shareholders and the PE investors intend to have the company go public in China in the future. If a PE investor is from China and uses RMB to acquire the shares listed in Hong Kong or the US, or other stock exchanges outside China, it will need to go through the foreign exchange approval procedure, which is a big challenge in terms of managing the timing and coordination with the stock exchanges and regulatory authorities outside China.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

Break-up fees and exclusivity clauses are acceptable under the PRC law and can be seen in PE deals, including acquisition of public companies. The usual break-up fees would normally be the actual expenses incurred by the investor or the target, e.g., legal due diligence and financial due diligence-related costs, and sometimes it can be set at about 1%–1.5% of the equity value. However, if the liquidated damages far exceed the amount of the losses and damages actually incurred, the PRC law allows the paying party to petition the court to adjust such liquidated damages to an appropriate level. The exclusivity clause prevents the seller from pursuing an offer from another potential buyer for a specified period of time after signing the indicative offer/letter of intent (LOI) with the current potential buyer. The takeover of listed companies in China usually takes the form of a negotiated agreement between the bidder and the principal shareholder(s), which often grant(s) an exclusivity clause to the effect.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

PE investors would usually reference the latest financial statements of the target company in the transaction agreements, along with consideration adjustments and indemnity clauses favourable to the PE investors. The time period between the financial statement date and the closing will be an interim period during which the company side may not conduct certain activities without prior consent by the PE investor. Ratchet and earn-out mechanisms are also popular in structuring the considerations.

If a PE investor is on the sell-side, it will tend to limit representations and warranties to a very short list and the survival period thereof and any holdback to the minimum. If a PE investor is on the buy-side, it will require the controlling shareholder to have an extensive list of representations and warranties and, ideally, a personal liability or guarantee in case of any breach and, again ideally, with no survival period. If the buyer and seller are both PE investors, then both sides will tend to drive hard bargains on all those terms of the transaction.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

Seller-side warranties and indemnities are commonly seen in PE transactions to protect against the downsides, including any hidden and contingent liabilities that may pop up in the future. Escrow and holdback arrangements can be seen more often in buyout deals, and PE investors sometimes request personal guarantee or joint liability of the founding shareholders for indemnity-related claims.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Non-compete and non-solicitation are absolutely crucial and are typically seen in PE transactions. It is being seen more and more often that sellers and/or management are requested to provide ongoing support to the business with the commitment to stay with the company for an agreed term and reach certain performance targets.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Representation and warranty insurance is not often seen in China, but we have started seeing insurers offering such insurance products for cross-border PE and M&A transactions. Usually, the typical premium of such insurance is 1%–3% of the insured amount, which depends largely upon the jurisdiction, industry type and structure of the transaction.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

The seller's counsel will often request a cap on the amount for indemnification, which can be set at a percentage of the share transfer price, along with a survival period of the representations and warranties, such as six months or one year following the closing.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

In case of any serious or material defects or potential damages that may arise therefrom, a PE buyer may insist on an escrow amount to be put in place as recourse for any losses and damages. (Escrow Provisions in M&A Transactions, Part 1: "Contain escrow provisions to address buyer concerns over the seller's financial ability to satisfy indemnification provisions contained in the definitive agreement. Escrow Coverage: To guard against any post-closing financial loss, buyers insist on placing approximately 10 to 15% of the total purchase price in escrow accounts managed by third-party firms. These funds are generally held for a period of one to two years in interest bearing accounts, and are released to the seller in annual instalments, subject to adjustments and fulfilment of any indemnification obligations and authorised claims.")

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

If the commitments are provided by SPVs, the seller side will usually request a guarantee of the actual investor(s) or buyer(s).

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Sellers may request buyers to provide a parent guarantee, and/or bank reference letter.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

PE investors usually request an exclusivity clause in the term sheet and in the purchase agreement. In the case of the selling of the shareholders' breach of exclusivity, the buyer or investor can then assert claims for damages amounting to the fees and expenses it has incurred such as the fees for legal and financial due diligence.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

There are a variety of factors that need to be considered for an IPO exit, such as the company's financial performance, size and scalability, industrial sector and growth potential, and ultimately, from a legal perspective, compliance-related issues and the minimum requirements for an IPO in a given jurisdiction and listing on a particular stock exchange, along with the time required for the preparation and approval of the IPO. PE investors often struggle together with the company to find the most suitable place for the IPO and listing, and sometimes decide to unwind an offshore structure to go for the Chinese domestic A-share listing if that option can offer significantly higher multiples as compared to the overseas capital markets. Restructuring the company will take time and is subject to scrutiny by the CSRC.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

Customary lock-ups imposed on PE sellers, as a result of a China onshore IPO, will normally take one year and can be shorter if the IPO takes place overseas. This depends on the different stock exchanges.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual- track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Savvy PE investors always keep all the options open, although they may not necessarily strictly pursue a dual-track exit process from the beginning through the end. This may gain increasing popularity as listed companies and industrial giants may be willing to pay more as it takes a long period of time for an IPO to take place due to the lengthy regulatory procedure and waiting period. Equally the idea may increase in popularity when the capital market is not strong enough to warrant the greater returns.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Although PE investors find debt financing desirable for helping generate higher IRR, and in particular for large offshore buyout and privatisation deals, PE investors are more likely to obtain loans from banks to finance the transaction, there are restrictions making debt finance more difficult to obtain or structure for China-related PE transactions. In the context of offshore transactions, there are certain regulatory conditions required for an onshore PRC entity to provide guarantee or security to any offshore lender or lender's affiliate. For instance, the SAFE prohibits an onshore guarantee to an offshore entity where the loan or debt finance is used to acquire another offshore company's equity interests and 50% or more of the assets of such target offshore company are located within the PRC. For onshore transactions, it was not until 2008 that the China Bank Regulatory Commission (CBRC) issued Administrative Provisions on Acquisition Loans of Commercial Banks and started allowing banks to make loans to finance acquisitions by companies that meet certain qualifications, such as bank credit rating A or above, but, in general, such acquisition loans are not open to PE investors (to be further discussed below).

In the PRC, in addition to bank syndicated loans, there are other channels for debt finance, e.g., a Chinese unit trust plan can be raised by a Chinese-licensed trust investment company, and then such trust investment company will loan the sums to PE investors. Also, asset management companies with a proper regulatory licence in China can also raise funds or use their own funds (e.g., the asset management arm of an insurance company) to loan to PE investors. In the PRC, the debt market for PE is still emerging and yet to be fully developed.

High-yield bonds in China still have high barriers for entry and higher costs, and as a result, they are not considered as a common source of debt financing for PE transactions.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

For growth capital deals, if the investment only results in a minority stake in the portfolio company, banks, for commercial reasons, will not consider debt financing for such investment anyway. Under the General Rules for Loans promulgated by CBRC in 1996, loans shall not be used for purposes of "equity investments" unless otherwise permitted by law. Although the Administrative Provisions on Acquisition Loans of Commercial Banks do not expressly prohibit loans from being made for PE funds, the loans are usually provided for industrial companies or conglomerates to make acquisitions. There are some recent developments that allow banks to provide financing to PE funds registered in the Shanghai Pilot Free Trade Zone, and we expect in the foreseeable future the CBRC will likely refine its policy to allow more debt financing for PE funds.

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For the offshore debt financing, the banks involved are usually financial institutions outside of the jurisdiction of the PRC, and the terms are therefore not subject to the PRC law or jurisdiction; but when the banks require collateral or security to be provided by any onshore entities within the PRC, the PRC regulatory restriction will come into play again. In particular, the SAFE restricts onshore entities from providing guarantees or security interests to non-PRC persons. This would make the lenders heavily rely on the pledge of shares or equity interests in the offshore and onshore operating entities, adding risk to the banks in case of default.

Debt financing can only be offered by individuals or financial institutions under PRC law. Therefore, if an inter-company loan is needed in China, to be in full compliance with the law, a PRC-licensed bank or trust company will have to act as trustee to bridge the loan, i.e., the lender to deposit the loan sums into the trustee bank's account, requesting the bank to forward the loan to the borrower.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

Banks in the PRC, due to regulatory restrictions, are normally not allowed to provide loans to companies for equity investment. More recently, on January 5, 2018, CBRC issued the Administration Measures on the Entrustment Loans of Commercial Banks (the "Measures"), which came into effect on the same date. Such Measures expressly prohibit the use of entrustment loans on equity investment. To our knowledge, most of the PE funds in the PRC rely on their own capital for investments and rarely use leverage or debt financing.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

For an offshore transaction, where a non-PRC PE investor acquires shares of an offshore holding company which owns interests in an onshore entity with operating assets, when such onshore entity repatriates dividends up to its offshore parent, such dividend will be subject to withholding tax at the rate of 10%, unless there is a tax treaty or equivalent providing a lower withholding tax rate. To the extent the PE investor sells any of its shares in the offshore holding company, such transfer will be deemed as an indirect transfer of equity interests in the onshore subsidiary in the PRC, and thus will be subject to filing with the PRC tax authority, pursuant to Bulletin 7 of SAT issued in 2015, and likely subject to capital gains tax (at the rate of 10%). If the offshore holding company owns subsidiaries in multiple jurisdictions, and China only represents one of the jurisdictions, then, in theory, the tax authority will only charge tax on the capital gains corresponding to the value attributable to the China subsidiary or subsidiaries.

For an onshore transaction, where a non-PRC PE investor acquires equity interests in an onshore company in China, then any dividend to be repatriated from such onshore company to the foreign investor will be subject to a 10% withholding tax unless a tax treaty or equivalent provides a lower rate. For the capital gains arising from the transfer of such foreign PE investor's sale of its interests in the onshore entity, it will be subject to a capital gains tax of 10%.

For offshore PE funds active in China, actions and steps must be taken to prevent such entities from being treated as a PRC tax resident. If not, all its global income of the fund(s) could be subject to PRC corporate income tax.

In respect of the carried interests, if they are being paid by an offshore PE fund to an offshore GP, provided that such offshore fund does not become a PRC tax resident, the carried interests received by the offshore GP will not be subject to PRC tax except where at the individual level, a GP member may need to pay PRC income tax if he or she is a PRC tax resident.

In contrast, in the context of an onshore PE fund (a.k.a. "RMB fund"), the law is not clear as to the tax treatment or tax nature of the carried interests – whether it should be deemed as a dividend and therefore subject to a 20% income tax rate, or be deemed as remuneration (i.e., compensation for services) and therefore subject to the 5%–35% progressive rates plus 6% VAT applicable to any payment of such remuneration.

As mentioned above, at question 1.1, if the future exit is likely to be an IPO in a non-PRC stock market, investors usually would request the controlling shareholders to form an offshore company as the future vehicle for financing and listing, commonly known as a "red chip" structure. Recently, some of those red-chip companies listed in overseas stock exchanges have decided to go private and then seek to get listed on a domestic A-share stock market, in light of the much better brand recognition on home turf and higher PE ratios and valuations offered by domestic investors; PE funds tend to participate in such privatisation transactions. Meanwhile, they become increasingly receptive to making direct investments into PRC entities with the hope of exit through A-share listing or otherwise through sale to A-share listed companies. Onshore RMB funds have grown bigger in size and gradually dominated the market. That being said, offshore structure still has its appeal for TMT companies and some entrepreneurs, which may prefer an offshore structure for estate planning reasons, as they may find it difficult or prohibitively costly (often for tax reasons) to transfer onshore companies into an offshore family trust, while a red-chip structure can be easily put under an offshore trust.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

This largely does not apply to China, and as to incentives for the management team of a portfolio company, the tax treatment will depend on whether the plan is considered a stock option plan, a restricted stock plan, or something else.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

If the PE investor sells any of its shares in the offshore holding company, such transfer will be deemed as an indirect transfer of equity interests in the onshore subsidiary in the PRC, and thus will be subject to filing with the PRC tax authority, and likely subject to capital gains tax (at the rate 10%) as mentioned above. For the capital gains arising from the transfer of such foreign PE investor's sale of its interests in the onshore entity, it will be subject to a capital gains tax of 10%.

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9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

The most recent change made by the tax authority is the issuance of the amendment to the Individual Income Tax Law of the People's Republic of China in 2018 (the "Individual Income Tax Law"), which introduces the Controlled Foreign Corporation rules (the "CFC rules"). Under the CFC rules, a PRC tax resident shareholder is subject to tax on undeclared profits kept without reasonable business reasons by a controlled foreign company incorporated in a jurisdiction with an effective tax rate obviously lower than that of the PRC. That is, a 20% dividend tax may immediately apply even if the dividend received from the foreign company is not yet distributed to the individual. The introduction of CFC rules is one of the general-anti avoidance rules (GAAR) that is being implemented in China.

As mentioned above, a PE investors' trade sale at offshore level would trigger the PRC indirect transfer tax issue. In early 2015, the SAT has issued Bulletin 7 as an amendment to the Circular 698. Bulletin 7 has made a change making the Circular 698 filing from compulsory into voluntary, but increases penalties for failure to make the required tax payment and adds burden of reporting on the buyer as well. It also clarifies and adds detailed tests for what constitutes "reasonable commercial purposes" for a transaction structure. Failure to meet such test could result in tax adjustment and even penalties. On October 17, 2017, the SAT issued a new guidance (Announcement [2017] No.37, the "Announcement 37") on withholding tax on PRC-originated income, along with official interpretations, superseding Circular 698. The Announcement 37 came into force on December 1, 2017. In addition to those amendments on tax filing procedures, it is worth noting a new change that allows such withholding tax to be deferred until the paid purchase price has exceeded the cost base of the corresponding equity interests so transferred. This is intended to ease the tax burden of the sellers and reduce the liquidity pressure on both sides.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

A major regulatory development impacting PE investors is the promulgation of the Interim Measures of the Supervision and Administration of Private Investment Funds, by CSRC on August 21, 2014. Such Interim Measures require filing and registration of any and all forms of PE investment funds formed in China. Such filing and registration shall be made with the Asset Management Association of China (AMAC), which is affiliated with CSRC.

On August 30, 2017, the Legal Affairs Office of the State Council issued a draft regulation seeking public comments, the Interim Regulation of the Administration of Private Investment Funds, which intends to beef up the protection of investor rights in fund raising and investment activities. It also sets out a list of circumstances where an individual/entity would be forbidden to act as a fund manager or a principal shareholder or partner thereof, e.g., creditworthiness problems such as failure to repay past due indebtedness. In respect of foreign players' involvement in fund formation in China, in light of the SAFE restrictions on conversion of foreign exchange capital into RMB for onshore equity investments, some select municipalities (such as Shanghai, Tianjin, Beijing, and Shenzhen) have issued "QFLP" measures to grant special approvals to certain qualified foreign PE players to set up "qualified foreign [invested] limited partnership(s)" (QFLPs) in their local jurisdictions. Those QFLP funds normally take the form of onshore limited partnership and can convert an approved quota of foreign capital into RMB for onshore investments.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

Under China's current regulatory regime on foreign investment, the national security review applies only to mergers and acquisitions involving Chinese companies and foreign investors under certain circumstances. If the invested domestic enterprises involve military or military-related products or services, national defence-related products or services, agricultural products, energy, resources, infrastructure, significant transportation services, key technology and heavy equipment manufacturing, a national security review will be triggered. In 2015, interim procedures for a national security review of foreign investment in all free trade zones in Shanghai, Tianjin, and the provinces of Guangdong and Fujian, were published by the State Council's general office on April 20. The Circular clarifies standards for conducting security reviews of foreign investment that may affect national security or involve sensitive investors, acquisition targets, industries and technology, as well as other areas. In addition to M&A transactions, a greenfield investment may also trigger national security review. However, currently there is no such unified national security law at central level to regulate foreign investment.

The new Foreign Investment Law in 2019 also provides that "a foreign investment security review system will be established" and further specifies that "decisions made on those National Security Review cases shall be final". However, the Foreign Investment Law only provides general principles, leaving more details for the future implementation rules. It is also unclear how this shall reconcile with the existing national security review regime in place.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

Due diligence is often a critical part of a transaction, and it serves many purposes. In an acquisition of a domestic Chinese company, the investor may use due diligence to, among other things, help identify issues that:

- Affect the decision of whether to do the deal or abandon it.
- Bear on purchase price or risk allocation.
- Impact post-closing operations or integration.
- Require conditions to closing.
- Require other special treatment.

PE investors normally engage law firms to conduct legal due diligence. The law firm will generally review documents provided by the target as well as publicly available information and materials obtained from other sources and will then provide a summary of its findings to its client in the form of one or more legal due diligence reports. Legal due diligence is generally one aspect of a larger due diligence process that may include inquiries into the following matters:

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- Accounting.
- Financial.
- Internal controls.
- Tax.
- Technical.
- IP.
- Operations.
- Labour.
- Product.
- Customer.
- Supplier.
- Environmental.
- Other.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Dictated by their home-country anti-corruption related laws, funds with members from countries such as the US, Singapore, and UK will often include anti-bribery covenants and indemnity clauses in the transaction documents, and often require anti-corruption related due diligence before signing the deal.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Natural persons that are directors, officers or employees, could be held liable for losses and damages he or she has caused to the company if he or she acted against the law, regulation or the company's articles of association when performing duties for the company. But for entities such as a PE fund acting as a shareholder of a portfolio company, there is no express provision that imposes any liabilities on an entity (acting only as a shareholder) except under the PRC Criminal Law where such entity has engaged in any criminal activities which constitutes a "crime by an entity". This also applies to a portfolio company which can be subject to criminal liability only if it, in itself, has engaged in criminal activities in violation of the Criminal Law, otherwise it can only be subject to civil liability for losses or damages it has caused to a third party on a tortious or contractual basis or otherwise in violation of the law.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

A common misconception of some foreign PE investors is the inclination not to choose PRC law as governing law and not to use PRC court and arbitration tribunals in case of any disputes with the PRC portfolio company or any of its Chinese shareholders. In reality, a foreign arbitration tribunal can take much longer to complete the arbitration proceeding, and has a major disadvantage, which is not being able to apply for pre-judgment relief such as freezing the defendant's bank account to ensure it has enough secured funds to pay for the award if any. Such privilege is only available for arbitration committees or tribunals within the PRC.

Thus, for foreign arbitration tribunals, the parties will have to wait for the local court to review the foreign arbitration award and then proceed with the enforcement; this process could take months on top of the arbitration proceeding. By such time, the defendant could have already moved or hidden funds elsewhere or even become bankrupt, leaving little for the plaintiff to recover for its losses and damages.

In a recent regulation of MOFCOM in 2018, the ultimate controlling person of the foreign investor must make a filing with the MOFCOM or its local counterparts. As mentioned above, if the ultimate controlling shareholder(s) are PRC residents, the failure to complete Circular 37 registration will result in penalties and even failure to repatriate profits to offshore shareholders including any PE investors.

Another practical tip for foreign PE investors to manage PE transactions in China is to focus attention on the management/founder's roles in the target company. In the dynamic market with a unique Chinese culture that values relationships, the founder and management team often play an essential role that "makes it or breaks it" for the success of a company. Therefore, a sound PE investment structure must fully align the interests with the founder and the management team and install a proper mechanism that ties the founder/management with the growth of the company.

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The firm's pre-eminence in the field of PE and VC investments and capital markets means it regularly handles the largest, most complex and demanding transactions in China and works with clients and other law firms all over the world. We have represented numerous domestic and foreign GPs and institutional investors in the formation of all types of PE funds, including buyout funds, real estate funds, mezzanine funds, VC funds and FOF. For PE investment and PE financing, our services run the full spectrum of stages from start-ups to IPOs and post-IPO mergers and acquisitions. Zhong Lun is also renowned for handling the most complex and challenging dispute resolution matters for PE clients.

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Finland

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

Finland provides a very stable and predictable regulatory and cultural environment for private equity activity and the local custom and process for private equity deals is broadly similar to, for example, the US or the UK with relevant transaction documentation being (almost without exception) in English.

A leveraged buyout of a majority interest in the target company remains the most common type of private equity transaction in our jurisdiction, although there are some early indications that sponsors with broad investment mandates and/or the ability to invest from different funds (depending on deal size) may be adopting more diverse investment strategies. It is common that key members of management invest alongside the fund. Depending on whether management holds shares in the target prior to the transaction, the management investment will often take the form of a post-tax roll-over or a new investment.

We are continuing to see a healthy flow of private equity deals and are experiencing activity across sectors and deal sizes. Examples of active sectors include B2B services (particularly IT services and the technology space generally), health and social care and energy. In terms of private equity transactions, recent examples include, e.g. the acquisition by Adelis Equity Partners of invoice lifecycle services company Ropo Capital and the acquisition by Providence Equity Partners of OpusCapita Solutions.

We have not seen significant changes in the structures of private equity transactions (also see question 4.2 below). The main changes relate to ongoing industry-specific regulation and reorganisations that affect the commercial dynamic of the relevant industries, including, as examples, the health and social care and transportation industries.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

The current reasonably high volume of deals is driven in part by the stable overall outlook in the Finnish economy. Moreover, factors that drive private equity transactions include the unprecedented amount of capital available to funds focusing on the market, the availability of cheap debt, the perceived stability and transparency of the market and the broadly attractive technology sector. There is a large number of small- and mid-sized companies in Finland that are a good fit with private equity. We have seen several domestic and international private equity sponsors raise separate funds that cover the full spectrum of deal size and sector categories in our market, which further drives demand for deals. In order to avoid the intense competition surrounding coordinated sales processes for the best assets, funds are also tapping into attractive assets through a smaller initial investment, followed by multiple add-on transactions.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

We expect continued high deal volumes in certain industries, including technology (particularly B2B technology services and fintech) and health and social care. The developments in the latter sector are closely tied to the overall health care reform in Finland, expected to be a top agenda point for the new government to be appointed following the general elections in April 2019.

Private equity is expected to remain active, with a record amount of dry powder in new funds with broad mandates (including both majority and minority investments) aimed at tapping into all market segments (venture, small-, mid- and large-cap). We expect private equity sponsors to continue to leverage on the increased sector knowledge gathered by them and focusing increasingly on certain sectors and industries.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Transactions involving private equity investors are typically structured through one or more Finnish special purpose vehicles organised as limited liability companies. The number of vehicles in the acquisition structure depends on the requirements of the contemplated financing providers for the transaction. Unless mezzanine or other junior loan arrangements are contemplated, the acquisition structures have traditionally been relatively simple with one or two holding companies. Due to existing and contemplated interest deductibility limitations and other tax and publicity reasons, shareholder loan financing arrangements have, in certain recent transactions, been replaced by other preferred equity instruments.

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2.2 What are the main drivers for these acquisition structures?

The acquisition structure is usually driven by taxation and the requirements of debt financing providers to achieve structural subordination. Also, certain structures have been adopted to facilitate minority or management ownership arrangements.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

Equity investments into portfolio companies are customarily structured into ordinary and preferred share instruments where the allocation between different instruments and the preferred share return percentage are agreed in order to provide an asymmetrical return profile for the management investors as compared to the institutional investors based on the investment case (premised on the management business plan at hand). Preferred shares customarily carry a fixed, annually compounding interest. In Finnish private equity funds, the fund manager's carried interest is usually calculated on the basis of the fund's aggregate returns.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Usually, private equity investors take majority positions or require other ways to ascertain sufficient control and possibility for an exit. If a private equity investor takes a minority position, the shareholders' agreement would customarily include similar provisions as in majority investments. Such provisions are designed to protect the investment case and exit opportunities, including veto rights, information rights, board participation and governance provisions, rights to participate in new equity investments, drag-along and tag-along rights and transfer restrictions.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

In typical cases, management are allocated between 5% and 15% of the ordinary equity, but the allocation depends also very much on the deal size and the proportion of preferred and ordinary instruments of the private equity investor compared to the management (amount of sweet equity). In small- or mid-cap private equity deals where the management sellers may remain as significant investors, the amounts of equity allocated to them may also be higher. The management typically need to sell their shares to the private equity investor or a person nominated by the private equity investor in case of a leaver event. The purchase price is typically equal to market value in case of good leavers and original value or significant discount in case of bad leavers. Alternatively, or in addition to such good leaver and bad leaver provisions, the management investment can be subject to a vesting schedule, which usually provides for linear vesting of the management's shares during a three to six-year period from investment. In addition to such management vesting and call option rights, the management's ownership is customarily subject to strict transfer restrictions, drag-along and tag-along provisions, and non-competition undertakings.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Bad leavers are usually management members who have committed a material breach of the shareholders' agreement, been dismissed on personal grounds (based on applicable employment legislation) or have voluntarily resigned from the target group. Good leavers are usually management members whose employment or service relationship has ended for other reasons, such as retirement upon statutory retirement age, death, permanent disability, or termination by the company without personal grounds (e.g. based on redundancy).

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

Governance arrangements are typically based on shareholders' agreements among the private equity investor and other shareholders, such as management. There is no requirement to publish corporate governance arrangements in a non-listed company, and e.g. employees do not have a statutory right to be represented in any decision-making body. It is common, especially in larger portfolio companies, to appoint independent board members and, recently, private equity investors have generally invested in the corporate governance arrangements of their portfolio companies (including corporate governance reporting).

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Yes. Typically, the ownership share of the private equity investor is sufficient to enable control over all significant corporate actions, rendering veto rights of less importance. If a private equity investor is in a minority position, it would typically secure in the shareholders' agreement veto rights in relation to all significant corporate events, such as corporate restructurings, acquisitions and disposals, approval of changes to the business plan, as well as related party transactions.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

Veto rights are typically based on shareholders' agreements and are, as such, generally enforceable as contractual obligations binding upon the parties. However, a corporate resolution made at the shareholder or board level in violation of contractual veto rights may not necessarily be considered invalid solely due to a potential breach of the shareholders' agreement. At the director nominee level, it should be noted that the directors owe their fiduciary duties to the company and the shareholder collective and are not acting as representatives of any nominating shareholder. The directors'

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statutory fiduciary duties may, in exceptional cases, force the directors to act in a certain manner despite contractual veto rights (e.g. in insolvency situations).

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

Finnish law provides for a number of mechanisms aimed at protecting minority shareholders, including the right to demand a minimum dividend and the right to demand squeeze-out. Such minority protection mechanisms are typically waived in the shareholders' agreement. However, the private equity investor will need to adhere to certain statutory legal provisions that cannot be waived beforehand and are aimed at securing equal treatment of shareholders (such as majority and consent requirements applicable to certain corporate resolutions).

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Shareholders' agreements are generally enforceable in Finland. However, under general Finnish contract law principles, individual contractual obligations may be mitigated or set aside, should they, based on a case-by-case assessment, result in an unreasonable outcome. Shareholders' agreements are typically governed by Finnish law given the interplay with Finnish corporate law applicable to the company (while there are no specific limitations to agree otherwise). Extensive non-compete provisions are generally unenforceable, the assessment depending on, among other factors, the position of the party to which the restriction applies.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

There are no specific risks, requirements or restrictions applicable to the private equity investor appointing directors. Individual directors are personally liable for breaches of their fiduciary or other duties as defined in Finnish corporate law (also see question 3.3 above). It is common to take out directors' and officers' liability insurance for the benefit of the portfolio company directors.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

The directors have a fiduciary duty to act in the best interest of the company and the shareholder collective and are not acting as representatives of any nominating shareholder. A director's relationship with the nominating private equity investor, or his or her position as a director in another portfolio company, may sometimes give rise to potential indirect conflicts of interest. Such situations (as opposed to direct conflicts of interest) are not expressly regulated in Finnish corporate law and are therefore assessed on a case-by-case basis in light of the directors' fiduciary duties. Absent any personal benefit, it would typically be permissible for a director serving on the board of another portfolio company to participate in the decision-making concerning an arm's-length commercial transaction between the two companies.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

Apart from antitrust approvals (if required), corporate transactions do not generally require other regulatory approvals. During recent years, there has been a discernible shift in competition authorities' approval process, with an increasingly economist-driven approach making filings and related market analyses subject to further scrutiny. This has resulted in more complex antitrust processes and called for law firms' in-house expertise in economics.

Foreign acquisitions of entities or assets engaged in defence industries or production of dual-use products, or civil sector industries deemed critical to society, are further subject to a separate monitoring regime, and may require a separate confirmation by the government, as further described in the answer to question 10.2.

In certain regulated industries (e.g. financial institutions and infrastructure), target company permits and licences may further be subject to change of control types of provisions and obtaining consents/waivers regarding the same may thus have timing implications.

Other issues possibly impacting timing include more general (i.e. less jurisdiction-specific) considerations, such as obtaining potentially required consents from key contractual counterparties, etc.

4.2 Have there been any discernible trends in transaction terms over recent years?

Over the recent years, warranty and indemnity insurance has become an almost standard feature of private equity transactions. As investors have become more familiar with the underwriting process, we have also seen a number of transactions where the underwriting is finalised only after the transaction documents have been signed.

The Nordic region has proved to be an attractive market for the warranty and indemnity and related insurance products, with new insurance providers and brokers establishing a presence and increasing their focus on the region.

Other recent trends include the increased attention to compliance (e.g. GDPR) matters in the diligence process. Moreover, insurance providers and brokers are actively seeking to introduce new insurance products that can be deployed in the transaction context in combination with the warranty and indemnity insurance, including separate insurance products relating to environmental and tax matters, as well as separate insurance products that cover tail liabilities in connection with the closure/liquidation of private equity funds.

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5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Private equity investor-led public-to-private transactions (i.e. public tender offers) are typically negotiated deals recommended by the target board and backed-up by commitments from the major shareholders to sell their shares. One particular feature of Nasdaq Helsinki is the concentrated ownership of a majority of its companies. This typically means that obtaining irrevocable commitments from the main shareholders of the target company is a key feature for deal certainty.

One particular feature for private equity investors is that they often want to offer shares or an equity stake in the acquiring company to selected key shareholders of the target company, including its management. One of the key legal requirements in a public tender offer is that the target company's shareholders must be treated equally. There are therefore restrictions on the acquiring company's ability to offer shares or equity instruments to selected target company shareholders. In order for such arrangements to be permissible, they must be carefully structured in keeping with the guidance on the principle of equal treatment of shareholders.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

Typically, bidders seek to obtain irrevocable commitments from the target company's major shareholders, and this is typically a key feature for deal certainty.

There are legal restrictions on the target board's ability to provide deal protections due to the board's fiduciary duties towards the company and its shareholders, for example. However, the combination agreement that is typically entered into between the bidder and the target company in a friendly deal often includes some deal protection features, such as an obligation on the target company not to actively solicit competing transactions, limitations on the target board's ability to negotiate with competing bidders and an obligation on the target company to provide matching rights to the bidder should a competing bid be launched.

There are also legal restrictions on the target board's ability to agree to a break-up fee payable by the target company. There are precedents of break-up fees in public tender offers, but they are generally limited to the transaction costs incurred by the bidder.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

Locked box mechanisms have remained the prevalent choice particularly on the sell-side. Often, but not always, the locked box price is subject to an interest element calculated from the locked box date until completion (designed to compensate the seller for the target's expected cash flow during this period). On the buy-side, completion accounts are often the preferred choice, but are seen less and less in practice. Completion accounts are more common in deals that do not involve private equity players.

Earn-out elements are sometimes seen particularly in small-cap transactions and the tech sector in particular. Due to controls imposed on the target's operations during the earn-out period, and the fact that earn-outs are prone to disputes, parties quite often seek to find a compromise around a fixed consideration rather than pursuing an extended negotiation on an earn-out structure.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

As noted in question 6.4 below, the introduction of the warranty and indemnity insurance product has to some extent changed the landscape regarding the scope of warranties/indemnities. As private equity sellers look for a "clean exit", in the absence of an insurance solution, the warranty catalogue would typically only cover the fundamental warranties regarding capacity, title and capitalisation. The warranty and indemnity insurance product has, however, allowed private equity sellers to provide a more comprehensive set of warranties, the scope of which has become rather standardised. Shareholders' agreements typically require equal treatment of shareholders in drag-along situations which leads to management offering an equal set of warranties as the private equity seller. Management would not provide a separate, stand-alone set of warranties as is customary in certain jurisdictions.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

The typical scope of covenants includes restrictions on how the target is run between signing and completion, assistance in competition filings and confidentiality. Private equity sellers are seldom willing to give non-competition/non-solicitation undertakings, whereas such covenants are more commonly required from management. If management rolls over to the buyer's equity incentive scheme, non-competition/non-solicitation provisions are typically included in the buyer's shareholders' agreement and may thus not be as critical in the purchase agreement.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

It is very common for warranty and indemnity insurance to be provided as a staple solution in sponsor-led sales processes and the existence of the insurance solution allows for the buyer to obtain broader warranty and indemnity-related coverage than they would otherwise be able to obtain. During recent years, we have seen an increased focus on the Nordic market by insurance brokers, both in terms of local team presence and marketing of specialised insurance products, e.g. for tax and environmental indemnities and fund closure situations.

The policy limits broadly follow the general market practice for monetary indemnity limitations and are rarely subject to extensive negotiations. Deal-specific carve-outs to coverage are typically associated with sector-related matters or specific findings or scope-related limitations in the due diligence process. The slate of general

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exclusions is relatively established but practitioners should be careful in safeguarding against a trend to formulate the general exclusions overly broadly. Particular focus is often given to protection against adverse developments or events that occur between signing and closing, and separate insurance coverage is sometimes obtained to cover such events (so-called "new breach cover").

Finland is a jurisdiction that is not particularly prone to litigation and parties often find a way to settle disputes arising in the context of an M&A transaction rather than proceeding to arbitration. This may, to some extent, affect the pricing of the warranty and indemnity insurance product.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Standard liability limitations regarding breaches of non-fundamental (business) warranties include (i) a liability cap typically in the range of 10–30% of enterprise value, (ii) a basket/deductible (typically around 1% of enterprise value), and (iii) the *de minimis* (typically around 0.1% enterprise value). For fundamental warranties, liability is usually capped at enterprise value and no basket or *de minimis* applies.

The limitation period for warranties typically varies between 12–24 months, save for fundamental, tax and environmental warranties, where the limitation period is longer.

In Finland, it is established market practice for all information in the data room (that is "fairly disclosed", a concept defined in the purchase agreement), rather than just the specific details set forth in a disclosure letter/memorandum, to constitute disclosure material for the purposes of qualifying the seller's operational warranties.

Liability for breaches of covenants and undertakings is typically not limited.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Escrow arrangements for private equity sellers are rare but sometimes seen, e.g. in situations where a fund is coming to the end of its term. The rise of warranty and indemnity insurance has further reduced the need for these arrangements. As noted in question 6.4 above, we are also seeing insurance solutions aimed at fund closure situations emerging in the market.

Private equity buyers sometimes require an escrow or other form of security from sellers that are private individuals, but where such sellers roll-over to the buyer's equity incentive plan, the private equity buyer often becomes comfortable with the recourse available against the seller's interests in the plan.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

While the comfort required by sellers as regards the availability of financing varies, in small- and mid-cap deals with a private equity buyer, sellers quite often accept a narrowly construed financing condition that is tied to the bank not refusing to fund its commitment under an executed term sheet and commitment letter attached to the purchase agreement. In highly competitive and especially larger transactions, sellers may require fully executed financing documents to be available at signing, which naturally increases transaction costs for unsuccessful bidders.

Equity commitment letters are increasingly required in deals involving a private equity buyer, in particular in larger transactions and ones involving a foreign private equity buyer or seller. Equity commitment letters are often addressed to both the buyer SPV and the seller.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are very uncommon in the Finnish market.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

Due to institutional investor expectations, a private equity seller will often be required to retain a significant stake in the company following the IPO. The private equity seller will therefore often not be able to exit its entire stake in the company in connection with the IPO.

A successful IPO requires a high degree of planning and preparedness and a streamlined process. The company should ensure that sufficient resources are available for the IPO project.

Private equity owners often have representatives from their organisation on the board of directors of the public company following an IPO. There are certain legal restrictions on such a board member's ability to share sensitive non-public information concerning the company within his/her own organisation. Such restrictions can sometimes be challenging for private equity owners.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

The customary lock-up period for private equity funds is 180 days.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Dual-track processes have become more popular in recent years due to the attractive valuations available in the public equity markets. The extent to which the IPO and M&A processes are actually run in parallel varies from case to case. In some cases, both tracks have been run in parallel throughout the whole process, but in our experience that is more the exception than the rule. While there have been several private equity IPOs in recent years, the majority of dual-track processes have resulted in trade sales.

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8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Senior secured bank debt remains the most common source of debt funding in Finland. Small- and medium-sized private equity deals are mostly financed by Nordic banks, whereas international bank syndicates are more common in larger deals. Mezzanine financing has also been used in some deals.

There has been an increasing interest for alternative financing channels in Finland and the Nordics and there are some Nordic and Finnish credit funds and insurance companies focusing on direct-lending in the Nordic region for small and medium-sized companies. Debt financing in private equity deals is, however, still dominated by bank financing and the aggregate volumes of financing provided by credit funds have been quite low.

Capital markets-based funding is regularly considered in private equity deals, although the number of transactions materialised in Finland has been quite low. In the infrastructure and real estate sectors, we have seen some debt capital market transactions implemented either in the form of listed bonds or private placements. This type of funding is more common for refinancing transactions.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

Debt finance structures are mostly affected by tax legislation, including interest deduction rules and requirements for arm's-length transactions, as well as Finnish corporate law. For tax considerations, please see section 9 below.

There are certain restrictions under corporate law that must be considered in relation to acquisition finance structures, in particular, the corporate benefit requirement and the financial assistance prohibition. These rules restrict, to a certain extent, upstream security and, for example, upstream guarantee arrangements.

The priority of debt financing is in most cases implemented through contractual arrangements, but structural subordination is also used and even required by certain senior banks.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

Bank financing is still the most common source of acquisition finance in Finland and the Nordic banks are the biggest lenders even though a growing number of alternative financing sources are offered also in Finland. The banking sector remains subject to regulatory developments and this trend is expected to continue on the EU and national level. The digital transformation is also changing the banking industry and it is expected that traditional banks will face increased competition from companies providing digital services and digital products.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Key tax considerations for private equity investors and transactions include structuring of the investment, whether there are any tax costs payable at the investment and how any income derived from the investment is treated in the hands of the investors. Further, the tax implications for the target company are of importance.

The acquiring entity is generally liable to pay a share transfer tax of 1.6% of the purchase price for a Finnish limited liability company target. Also, debt financing may be included in the transfer tax base in certain situations. The transfer tax can only be avoided in rare cases where neither the seller nor the buyer are Finnish residents.

Interest income paid to Finnish resident investors is subject to Finnish taxation. Interest income paid to non-residents is not subject to tax in Finland. This also applies to interest paid to investors through a fund organised as a limited partnership.

Dividends paid to Finnish resident limited companies are tax-free and partly taxable income when paid to Finnish resident individuals (e.g. management shareholders). When paid to non-residents of Finland, a dividend by the distributing company directly or through a fund organised as a limited partnership, is subject to withholding tax based on the relevant tax treaty between Finland and the investor's country of residence. The dividend may be exempt based on the EU Parent-Subsidiary Directive or EU non-discrimination rules.

In an exit situation, capital gains are taxable for resident investors. For non-resident investors, capital gains are free from Finnish tax. The rules are the same whether the capital gain is derived directly by the investors or through a fund organised as a limited partnership.

The use of a Finnish limited liability company as an acquisition vehicle has traditionally been accepted and the interest expenses borne by such a vehicle have been accepted as tax-deductible costs (through group contribution also from the target company's taxable income) within the limits of interest deduction restriction rules (only interest costs up to 25% of adjusted EBITDA can be deducted). These rules have been adjusted to be in line with the EU Anti Tax Avoidance Directive as from 2019. An increase of the interest burden in the target company may be regarded as non-deductible if pre-acquisition loan financing is refinanced by a new investor or other related party financing.

If a Finnish limited liability company is used as an acquisition vehicle owned by a fund organised as a limited partnership and the target company is liquidated into the acquisition vehicle, the acquisition vehicle could, under certain circumstances, benefit from tax deductions on the goodwill paid on the target company's shares (i.e. purchase price exceeding the fair value of the target company's net assets).

The use of off-shore structures is not common, at least not in the structure below the Finnish top company or fund organised as a limited partnership. In such case, any income attributed to the off-shore entity would likely fall under the rules applicable on controlled foreign corporations (CFCs) and is thus subject to Finnish taxation.

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9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Direct share ownership is typically used to incentivise management of the target company. As subscription prices lower than the fair market value are deemed as earned income, management shareholding is typically implemented directly in connection with the acquisition at the original acquisition valuation.

Shares can as such be tailored in different ways, but if the dividend on shares is based, directly or indirectly, on the shareholder's work input, the dividend can be taxed as earned income.

Stock options are sometimes used, but the option benefit is taxed as earned income upon the exercise of the stock option. Stock options are normally used at a later stage when the value of the share has increased. Different contractual arrangements (e.g. management holding companies) can also be regarded as stock options for tax purposes, if the beneficiary carries very limited financial risk and is entitled to shares within the arrangement.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

It is possible for the shareholders of the target company to benefit from roll-over relief, if they transfer the shares with controlling vote of the target company to a limited liability company against share consideration. The possibility for cash consideration is very limited under the roll-over relief. The capital gain that was not taxable due to the roll-over relief only becomes taxable if such shareholders move their residence outside the European Economic Area during the subsequent five years. No roll-over relief is available when target company shares are transferred to a fund organised as a limited partnership or a subsidiary of such fund.

Due to a strict interpretation of the cash consideration limitation, it is under current case law not possible that part of the shareholders roll-over their shares tax neutrally to the acquiring entity against share consideration whereby other shareholders sell their ownership for cash. This all-or-nothing approach has been challenged and new case law could be expected in 2020.

Interest is deemed to be paid on an accrual basis to individuals, as the taxation practice on PIK loans has tightened. This impacts shareholder loans typically granted to management shareholders. Therefore, management loans have been recently converted into preference shares with similar effect except for the calculative interest not being tax-deductible.

Carried interest has so far been taxed according to the rules applicable to the form of such carried interest, i.e. normally as capital gain or dividends, although this has been challenged by the tax authorities in some cases claiming it constitutes salary income for the receiver.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

A ruling on PIK shareholder loans was issued in 2015 and the tax administration has since taken a stricter approach to interest accrual. It is no longer possible to postpone the taxation of interest income on the basis of deferral of the actual monetary payment. Another ruling from 2016 clarified the treatment of carried interest by lowering the risk of earned income taxation. More generally, the scope of earned income taxation has been widened to some extent by recent case law which may put different kinds of arrangements aiming to transform earned income into lower taxed capital income (e.g. capital gain or dividend) under scrutiny.

The treatment of structures where a fund has been organised as a Finnish limited partnership has been changed in 2019. Non-resident investors that are limited partners in the fund are only taxed for profit and gain when they would have been taxed for such income when invested directly in the Finnish target company. The law now requires that the limited partnership shall qualify as an alternative investment fund for the rules to apply. Regarding old funds established before 2019, there is a transitional provision according to which the new rules apply as from 2024.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

The AIFMD was implemented in Finland in 2014 through the Alternative Investment Fund Managers Act, which made several previously unregulated private equity funds subject to regulation. Depending on the amount of assets under management, an AIFM will either be required to be authorised by or registered with the Finnish Financial Supervisory Authority. Under the AIFM Act, an AIFM is required to comply with, e.g. rules regarding risk and liquidity management, valuation, marketing, securities depository and reporting.

Please also see our answers to section 9 as regards tax matters.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

In general, private equity investors and their transactions are not subject to any enhanced regulatory scrutiny that would not be applicable to other investors and industrial players and their transactions as well.

Although the Finnish government views foreign ownership positively, foreign investors need to be aware of the Act on Monitoring of Foreign Corporate Acquisitions in Finland, the purpose of which is to monitor and, if key national interests so require, to restrict transfer of influence to foreigners and to foreign organisations and foundations. Key national interest mainly refers to national defence, security of supply and functions fundamental to society.

Under the Act, a "corporate acquisition" occurs when a foreign owner gains control of at least one-tenth, at least one-third or at least one-half of the aggregate number of votes conferred by all shares in a Finnish company, or otherwise secures a holding that corresponds to actual influence. All corporate acquisitions concerning the defence and dual-use sectors always require advance approval by the Finnish authorities. In the non-defence sector, the monitoring concerns Finnish enterprises considered "critical for securing vital functions of society". In the latter case, investors are not required to

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submit an application prior to completing a transaction, but in practice applications are almost invariably submitted prior to completion.

As regards the defence and dual-use sectors, monitoring covers all foreign owners. In other sectors, monitoring only applies to foreign owners residing or domiciled outside the EU or EFTA.

Matters concerning the monitoring and approval of corporate acquisitions are considered by the Ministry of Economic Affairs and Employment, which also requests opinions from other authorities to the extent necessary. The Ministry must approve the corporate acquisition unless it may conflict with a key national interest. If the corporate acquisition may conflict with a key national interest, the ministry must refer the matter for consideration at a government plenary session.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

Private equity investors typically tend to conduct a thorough legal due diligence. Timeframes, materiality and scope vary depending on the size and type of business (e.g. regulated/unregulated) of the target. Warranty and indemnity insurance has become very common and has had an effect on the scope and materiality of the due diligence (which need to satisfy the requirements of the insurer). External counsel is customarily engaged for legal and compliance due diligence, with reporting typically being on a "red flag" basis.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Often rated as one of the least corrupt countries in the world, bribery and corruption have not historically been viewed as significant issues in Finland. However, increased public and media attention to bribery and corruption has led to such matters being scrutinised more thoroughly in due diligence and contractual protection to limit risks and liabilities (similar to international practice) is relatively standard nowadays.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Shareholders of limited liability companies in Finland are, as a starting point, not liable for the obligations of the company and any "piercing of the corporate veil" by courts has, in practice, been very rare and only due to very special circumstances. However, in light of recent precedent rulings, we expect that claims to pierce the corporate veil may become more common.

Assuming there are no ties (other than same ultimate private equity fund ownership) or contractual arrangements between portfolio companies, there is no specific base under Finnish law that would trigger liability for a portfolio company for the liabilities of another portfolio company.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Finland provides a very stable and predictable legal and cultural environment for successful deal-making, offering significant deal security and traditionally a low risk of post-closing disputes. Transactions are negotiated and documented in a manner that closely reflects UK and US traditions and practices. In terms of what is distinct, one thing that is noteworthy is the level of trust and transparency that parties will expect from one another in the context of doing deals in Finland. Finns have a strong tradition of being worthy of their word. This culture is also reflected on the adviser side, which is known for high ethical standards and sophistication.

The Finnish language is clearly one distinguishing feature of deal-making in Finland given that few people outside of the country speak it. This is mitigated by the fact that, generally without any exceptions, all significant deals are negotiated and documented in English. Another feature of the M&A environment is the fact that the Finnish state continues to hold substantial stakes in many Finnish industries with certain non-strategic assets being administered by Solidium Oy and Vake Oy, both investment vehicles of the Finnish state.

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France

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

The French private equity sector is well-developed and growing.

In the past couple of years, this sector has been subject to several favourable factors: (i) availability of financing sources; (ii) association with tax and labour law reforms; and (iii) a positive global outlook. Together, these have contributed to the improvement of this sector in France.

Funds provided by the transaction to the investee company can be used for a variety of entrepreneurial purposes. Private equity is used to: finance growth for start-ups but also established companies as replacement capital when the ownership structure changes; to realise succession plans; or as distressed investment for turnaround financing.

A great variety of businesses in different industry sectors benefit from private equity, including those in high technology, industrial, healthcare, consumer, services, financial and other sectors, and in different development stages from start-ups to large established companies.

In the last three years, we have seen a rising cooperation of investors with other strategic investors in private equity transactions. These new alliances are considered as the most common change in the private equity firms' business models, ahead of using leverage or financial engineering or focusing on active portfolio management.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

The growing attractiveness of the French market may partially be explained by the recent reforms intended to enhance the investment environment and to stimulate economic growth.

For instance, the wealth tax in France, called *l'Impôt de solidarité sur la fortune* ("ISF") which used to assess the total wealth owned by a tax payer has been replaced by the *Impôt sur la Fortune Immobilière* ("IFI") which only assesses property assets (please refer to question 9.4). Furthermore, there were significant changes with respect to capital gains, dividends, and interest, which are now taxed at a 30% flat tax rate.

Moreover, Bpifrance, the public investment bank, and the European Investment Fund ("EIF") provide support and facilitate access to funding (loans, guarantees equity) for enterprises, small- or mid-size, in any sector of activity from their early stages to a public listing.

A new alternative investment fund, the *Société de libre partenariat* ("SLP") was created. It possesses legal personality and is comparable to the English limited partnership. Designed to address key demands of investors, it allows greater flexibility and provides for legal certainty.

In order to further promote investment in French companies, the Pacte (*PACTE – Action Plan for Business Growth and Transformation)* legislation simplified the use of certain instruments that are typically used in private equity operations (i.e. the conditions of allocation of preferential right shares ("*actions avec des droits de préférence*"), BSPCE, advantages in relation to the French PEA, etc.).

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

In 2018, there were over 5,100 private equity backed buy-out deals, the larger number of deals registered in the last 10 years. With the continuing low interest rates, we expect private equity to remain active during 2019, though perhaps not at the record levels of 2018.

Two major trends may have an impact on private equity transactions. Firstly, reforms, under the liberal government, will continue to incentivise private equity investment. In addition to the measures mentioned previously, corporate tax in France is expected to be reduced from 33% to 25% by 2020.

Furthermore, geopolitical factors may also shift some European private equity initiatives to the French market. Recently, in the context of Brexit, British investments have been made in France in order to gain a foothold in Europe and certain projects that would have naturally been developed in the UK previously are being relocated to France.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

When a target is identified, a special purpose vehicle ("SPV") is

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created in most cases under the form of a *société par actions simplifiée* ("SAS") to gather all the investors under one corporate entity.

In addition to the vehicles mentioned above, we should also note a special purpose vehicle referred to as "NewCo", established to raise funds in order to acquire the target company. Subject to certain conditions, this vehicle allows to facilitate the consolidation for tax purposes and to offset the interests on debt against the target's profit (please refer to question 9.1 for further information).

When the private equity fund wishes to offer management packages to a large number of managers, they usually prefer to create a separate and unique structure under which all managers are part of ("ManagementCo").

2.2 What are the main drivers for these acquisition structures?

Private equity is mainly encouraged by financial considerations. It offers investors the opportunity to have an experienced fund manager invest their money according to the guidelines of the fund and distribute the profits amongst its members. This activity is often categorised as an "alternative investment" which entails a variety of investment techniques, strategies and asset classes which are complimentary to the stock and bond portfolios traditionally used by investors and which provide attractive returns, higher than public equities, stocks or bonds.

Tax rationales are the second driver to promote private equity investments. Last year, the French government increased tax incentives to attract private investors. The investors benefit from a lenient, even favourable, tax system including an income tax cut, exemption on capital gains or deferred contributions. For instance, when French tax residents make investments through private equity investment funds ("FPCR"), they may use a tax exemption on capital on gain.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

As explained above, private equity funds invest the funds in the target company.

Private equity fund managers are generally rewarded with fees income and a share in the profits of the fund, generally known as carried interest.

Furthermore, in a buy-out, private equity investments are often channelled through a new company ("NewCo") which raised the funds to acquire the target company. In this case, private equity funds invest a small amount of equity and use leverage, i.e. debt or other non-equity sources of financing, to fund the remainder of the paid consideration.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Yes, the investor's positions depend on its contributions on the capital. However, although the dispositions of the law offer a certain protection, the by-laws or a shareholders' agreement may offer higher protection to the minority shareholders. For instance, a minority shareholder may get a veto right on any strategic decision which may have a direct impact on the value of its investment such as a build-up, a security over the assets of the company, etc. In addition, minority investors may request other specific rights such as the appointment of a director, a reinforced right to information through reporting clauses, preferential shares with multiple voting rights, and, in some cases, the right to conduct an audit of the company.

These rules, which mainly relate to corporate governance matters and security transfers, are generally set out in a shareholders' agreement and reiterated to a certain extent in the by-laws of the acquisition vehicle, especially if incorporated in France under the form of an SAS, which offers great flexibility to tailor the by-laws to the shareholders' needs.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

In private equity transactions, investors will generally seek to acquire a stake in a target under preferential conditions. Thus, private equity investments are usually associated with a management package – offered to the managers of the target company.

It is also common market practice to have managers invest in preferred equity instruments, the return of which are higher than on ordinary shares but contingent on a certain level of global return, measured through the return on investment ratio established by private equity investors ("*le TRI, taux de rendement interne*").

Moreover, the terms of the exit itself can be a matter of consensus with other shareholders. The shareholders' agreement can anticipate this issue by requiring cooperation from the target company. For instance, a "drag-along" clause gives the private equity firm, as a majority shareholder, the right to compel the other shareholders to sell.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

In order to reinforce management's involvement, the concepts of good and bad leavers are often introduced to determine the price for the shares in case the shareholding manager departs. The usual position is that a good leaver will receive market value for its shares and a bad leaver will receive the lesser of the market value or nominal value (although other means may also be negotiated).

A management equity holder can usually be treated as a good leaver if they leave after a negotiated contractual period, for the following reasons: death; a mental or physical incapacity preventing them from continuing their involvement; or their dismissal or removal without misconduct.

In other cases, a management equity holder may be penalised through a bad leaver clause, in circumstances where they take the initiative to leave shortly after the private equity transaction or for any type of misconduct, subject to negotiations between the parties.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

Most private equity portfolio companies are registered as an SAS. The main idea behind the SAS is to offer a vehicle whose main

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operational rules can be set by the parties with very light statutory prescriptions. Such flexibility allows the setting up of governance structure to be adapted to a wide range of investors' profiles. In this type of vehicle, by-laws may be tailored to the investors' expectations: in most cases, some wish not to partake in any management role, preferring a supervisory role.

Such rules are generally set out in a shareholders' agreement and reiterated to a certain extent in the by-laws of the acquisition vehicle. In France, such arrangements are confidential whilst by-laws are public. Thus, any confidential information should be further set out in the shareholders' agreement.

Following recent trends, minority investors have preferred the role of an observer "*censeur*". As such, the investor is entitled to attend all meetings of the board of directors and present its observations but has no voting rights. The rationale underlies a supervisory role to ensure profit but not to participate fully in the management.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Yes. Private equity investors generally enjoy veto rights, not conferred by law but set out in a shareholders' agreement. These veto rights allow such investors to oppose any decision which goes against the very essence of their investment. The list of veto rights may include any commercial or financial matters related to the main assets of the company, which may have an impact on the investment.

Minority private equity investors also have veto rights which confer protective provisions in order to protect their minority position against the majority shareholders. These veto rights mainly relate to corporate governance matters and security transfers, or dilution issues.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

As stated above, the veto arrangements are not provided by law but by contractual provisions set forth in a shareholders' agreement. Veto rights are effective between parties but not opposable to third parties.

The representatives' veto rights need to be balanced with the corporate purpose of the company. With regard to third parties and in principle, managers have broad powers to act on behalf of the company they represent, within the limits of the corporate purpose of the company.

The company may also be engaged even when the acts do not fall under the corporate purpose of the company, unless it is proven that the third party was aware that such an act exceeded the said purpose. Thus, the company bears the burden of proving the bad faith of the third party, by demonstrating that the latter knew that such acts exceeded the corporate purpose of the company.

In other words, despite a veto right of the board or general meeting, the legal representation of the company may ignore such decisions and have the company legally bound with third parties. In such cases, they may be found liable towards the company and its shareholders provided that damage is proven which may also consequently result in dismissal.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

Majority investors shall not take any actions that unfairly prejudice the minority shareholders (oppression of a minority shareholder) and *vice versa* a minority shareholder cannot use its minority right to act against the interest of the company.

Certain duties may also be owed if the company is incorporated under a limited company form. Apart from the common rights granted by each share to their respective shareholders (for example, right to participate in the general meetings, voting rights, right to receive dividends, right to participate in any increase of the share capital, etc.), specific rights are also granted by law to minority shareholders, including the right to (i) request information and to question about the course of the company matters and its financial situation, and (ii) request the performance of a legal audit of the company before the courts.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

There are no such limitations or restrictions that would apply with respect to a French company with regards to enforceability. However, as mentioned below, under French law (as well as other laws), the shareholders' agreement only binds the involved parties.

Although not very common, the parties may submit the contract to laws and jurisdictions other than France, provided that there is no fraudulent intent. It is important to note that even when the contract is governed by a foreign jurisdiction, the contract shall still respect French public order dispositions.

As for the enforceability of a non-compete or non-solicit provision, its scope of application shall only be limited to the protection of the legitimate business interest of the company as well as limited to its geographical location and duration.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

Private equity investors must ensure that nominee directors are not disqualified or prohibited from acting as directors.

In the case of proven damage, a director who has committed mismanagement and not acted in the interest of the company may incur liability. Liability may be incurred in the case of harm caused by a breach of the law or of its contractual obligations, as well as by a management fault. The private equity fund may revoke its mandate to act as a director.

Moreover, directors may also incur liability in the cases of criminal offences such as (i) breach of trust, (ii) fraudulent circumstances, and (iii) where they have not designated an auditor requested by law. As a principle, the liability of the private equity investor will not be incurred based on the fact that it has appointed the director who has acted unlawfully and against the interest of the company.

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However, in certain circumstances, private equity investors may be considered as a *de facto* director. For instance, if the investor actively participates in the management of the company on a daily basis, then the investor will be treated as a director and the duties of a director shall also apply.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Among their key general duties, directors must avoid potential conflicts of interests. In order to ensure compliance with this principle, French law imposes efficient control measures to directors in the form of a prior approval of any agreement arising between the company and its directors. In addition, it is forbidden for a director to obtain a loan or a credit from the company.

The French association for private equity investors in France Invest has also established a code of conduct which includes a range of good practices directed at portfolio management companies involved in the investment. In particular, these rules aim to ensure a higher degree of loyalty and transparency.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

Bearing in mind to better oversee foreign investments in France, the French law provides that any investment in sensitive sectors deemed crucial to France's national interests in terms of public order, public security and national defence, be subject to the prior compulsory approval of the Minister of Economy and Finance. The relevant sectors include the supply of energy and water, transportation and communication services, facilities and infrastructures that are deemed critical within the meaning of the French Defence Code, the production or trade of weapons and ammunitions, and the healthcare sector. Based on the latest news, the scope of the mentioned sectors may increase in the coming months.

In addition, any transaction which may have an impact on competition and anti-trust issues (subject to the fulfilment of conditions pertaining to the turnovers) is also subject to the prior approval of the Ministry of Economy and Finance or the European Union-based Commission.

Another important aspect underlies the requirement of the prior opinion of the Work Council of the company with regards to the decision of acquiring or investing in the company. However, such employee representations body does not have a veto right.

Finally, it is also important to mention the application of the *Loi Hamon* where, if the contemplated share transfer represents 50% or more of the share capital, all employees (in small- and medium-sized companies only) must be informed individually before the contemplated transaction, in such a way that it entitles them to make an offer to acquire the said shares.

4.2 Have there been any discernible trends in transaction terms over recent years?

French private equity has been recovering over the past two years and has recently benefitted from several favourable factors such as those mentioned throughout this chapter: tax reforms; positive global outlook; availability of financings from banks which altogether foster a level of trust to increase investments in start-ups; SMEs; and mid-caps.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

A public-to-private transaction generally involves several challenges. The acquisition process involving a tender offer is defined as a cumbersome transaction. There is a higher level of confidentiality towards the financial market which adds to the difficulty of collecting information for due diligence purposes as well as to gather information from the management team and shareholders of the target company. Excluding minority shareholders is also a challenge. The squeeze-out can only be effected if the offering party has a shareholding of at least 95%.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

The Financial Markets Authority ("*Autorité des marches financiers*") ("AMF") publishes a set of rules and regulations concerning public takeovers, in order to ensure the protection of private investors in public acquisitions. They aim to (i) establish equal treatment and access to information by securities holders concerning the offer, (ii) promote market transparency and integrity, (iii) level the playing field for alternative bids, and (iv) ensure fairness in transactions and in competition among bidders.

Break-up fees are allowed in public-to-private transactions, not by virtue of law but through contractual provisions.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

On the seller's side, private equity investors prefer not to offer warranties and consequently only provide such warranties on the title of ownership of their shares or capacity warranties. On the buyer's side, however, private equity investors need to be reassured and thus request a series of guarantees.

Moreover, the "locked-box" structure is fairly common as it offers in particular a firm price independent from the normal activity and greater control over financial information. In return for the price protection, the seller undertakes not to extract value (in the form of cash, assets or other benefits, together defined as "leakage") from the target group in the period from the locked-box date to completion.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

As mentioned above, the private equity seller usually avoids providing warranties and indemnities. However, in order to

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mitigate such a situation, the seller accepts to offer warranties, but on a smaller scale and for the shortest duration period possible.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

As mentioned above, in the locked-box structure, it is essential that no "leakage" of value occur from the target company during the period between the balance sheet date and completion of the transaction. Therefore, a private equity seller will usually provide pre-closing undertakings ensuring that no value has been extracted from the company. The business shall also continue to be conducted in its ordinary course (no distributions on dividends, payments or returns, no transaction other than on arm's-length terms or no waiver towards third parties).

Moreover, the private equity seller may undertake some other restrictive covenants or a period of time after the sale such as not to compete and/or solicit the employees.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Representation and warranties insurance, "*assurance de garantie de passif*" is more and more used to "bridge the gap". This flexible tool covers the consequences for breaches by transferring the risks from the private equity seller to the insurer. It allows the private equity seller to reduce the level of the guarantee that it must grant, and the consequent commitments. At the same time, it enables the private equity buyer to benefit from strengthened insurance.

Given the cost inherent to this insurance, investors in lower middle scale and smaller acquisitions prefer to negotiate contractual representations and warranty. The premium costs on average between 1% and 1.6% in Western Europe. The policy limits are typically between 10% to 20% of the transaction value of the deal, but vary according to the scope of coverage of the policy.

Insurers typically choose to exclude from their coverage the following risks deemed uninsurable: (i) the non-availability of net operating losses; (ii) breaches known by the insured; (iii) purchase price adjustments; (iv) fines and criminal penalties; (v) anti-corruption legislation; and (vi) in some cases, market specific exclusions (medical malpractice, product liability, etc.).

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

The private equity seller's liability will be limited to a relatively short period of time and with a certain scope confined to title and capacity. As mentioned above, private equity sellers usually seek to obtain a guarantee cap as low as can be associated with individual and global deductibles.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Escrow accounts are used in some transactions. However, as indicated above, private equity sellers attempt to resist such covenants, preferring to avoid any warranty.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Private equity funds usually provide an equity commitment letter to the seller. This letter agreement sets forth the terms and conditions by which the private equity fund is bound to provide equity financing to fund an acquisition.

Where commitments are breached, a specific performance or enforcement may be difficult to obtain since such commitments are themselves subject to conditions precedents. In most cases, a seller may obtain compensation for their damages instead of specific performance.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Break-up fees are not commonly used to limit private equity buyer's exposure in France.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

This is an exit strategy used by private equity providers for larger deals, due to the fact that when the proper market conditions are available, this method is likely to enable the investor to realise the highest return on its investment. There are a number of key issues which need to be considered by private equity sellers who are considering an IPO exit including: (i) the timing for performing such exit, which underlies the analysis of the prevailing economic conditions, the perception of valuations in the markets, the vibrancy of the IPO markets (to mitigate the market risk); and (ii) to enter into lock-up agreements (they prohibit company insiders such as private equity investors, major shareholders, from selling their shares for a set period of time). As such, lock-up agreements ensure that a significant number of shares are not sold shortly after completion of the IPO exit. The terms of lock-up agreements may vary. Please refer to question 7.2 for further information related to the holding period.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

The investor seeking to perform an exit will be exposed to fluctuations and other market risks for a certain amount of time after the IPO is carried out. As mentioned above, the terms of lock-up agreements may vary.

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7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Although a dual-track strategy is possible in the French market, transactions are most commonly conducted through sale rather than IPOs.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

It is essentially debt financing provided by a banking pool, combined with mezzanine financing (i.e. a hybrid between debt and equity financing, such as convertible bonds or exchangeable bonds) that gives the lender higher returns than senior debt but lower returns than equity. It may also give, as the case may be, the right to convert to an equity interest in the company, provided some conditions are met such as events of default.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

Financial assistance under French law is not permitted. It refers to assistance given by a company for the purchase of its own shares or the shares of its holding companies.

For instance, a target company cannot grant security over its assets as a guarantee towards the obligations of the holding company.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

In previous years, the financing of transactions was through mezzanine financing, composed of senior debt divided into tranches (senior, second lien) and junior debt.

However, in mid-cap acquisitions, we have seen a growing trend of financing through "unitranche" loans. Unitranche loans are defined as debt financing through one debt instrument, subject to the same terms, instead of both senior and mezzanine debt. This alternative provides the benefit of simplifying the documentation required and limiting the number of participations in the unitranche loan.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Investing in a French target is influenced by several tax incentives. First of all, private equity investors can benefit from an attractive tax consolidation regime. French corporations and their 95%-owned subsidiaries may elect to form a consolidated group in order to combine their profits and losses and, consequently, to pay corporate income tax on the aggregate result. The group will pay a single tax based on the taxable earnings of the group members, and consequently, allow the offset of losses of a group corporation against the profits of a company from the same group. In private equity investments, this regime allows for the charge of interest on the acquisition-related debt on the target's profit.

Moreover, a French mechanism "*the Carrez Amendment*", recently modified by the *Loi Finance pour 2018* (Finance Act for 2018), limits under certain conditions the deductibility of interest expenses on debt subscribed for the acquisition of qualifying participations by a French company not able to demonstrate that the decisions related to the acquired shares are made and that effective control or influence is exercised over the acquired entities either by the French acquiring company itself or by a company established in France, established in the EU, or in a country of the European Economic Area ("EEA"). Moreover, the interests paid to the foreign vehicle are only deductible if the entity is subject to income tax in its country of tax residence. As such, the use of off-shore structures is significantly limited.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

In France, taxation on capital gains and wages are different. Incomes from capital (interests, dividends, capital gains on shares) are taxed a 30% flat tax ("PFU") whereas salaries are currently taxed at the progressive rates of personal income tax (with a maximum rate of 49%) plus social charges. It is thus preferable to use the flat tax regimes on capital gains. However, the tax administration reserves the right to re-qualify the gain realised by the manager as salary and not capital. The French fiscal administration is very strict on the use of such mechanisms. In order to avoid such requalification, the manager should subscribe to significant investments to prove the risk taken.

Recently, France's highest administrative court, the *Conseil d'Etat*, has underlined that the capital gains in a management package granted to the manager, must be in relation with the risk allocated in the beneficiary's quality of investor, and not as a result of his performances in order to avoid being re-qualified as salary.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

The "Charasse Amendment" provides for a partial recapture of financial expenses borne by a French tax group. The recapture arises when: (1) a tax-consolidated company acquires shares of another company from an entity that is not part of the French tax group but that controls the acquiring company or is under common control with the acquiring company; and (2) the acquired company joins the tax group.

However, if the sellers become minority shareholders following the transaction, it does not influence the decision to opt for the tax consolidation regime. On the contrary, in the case of the majority, the "Charasse Amendment" may lead to the tax consolidation regime being renounced.

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9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

Since the beginning of this year, French tax residents have seen the suppression of the wealth tax in France, the ISF. Its replacement, the IFI, is a property tax, payable only on property assets – there is none on financial assets.

Moreover, the Finance Act for 2018 provided a decrease of the corporate tax rate. Currently set at 33.33%, it will gradually decrease to 25% in 2022.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

Private equity is regulated by a series of regulations such as the French Monetary and Financial Code, ethical rules, and is subject to the regulation and control of the French Financial Market Authority ("AMF") in addition to the European regulations ("OPCVM IV" and "AIFMD").

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

Certain transactions by non-EU foreign investors in relation to the acquisition of a French company that have strategic and/or sensitive business activities are subject to the prior approval of the Minister of Economy and Finance, on the grounds that they are in relation to the protection of military and national security interests and public order. These activities include, for example, those pertaining to energy and water supply, transport, communication, artificial intelligence, cyber security and public health. This list has recently been widened by a decree of December 1st, 2018, in relation to foreign investments, applicable since January 1st, 2019.

In this context, the foreign investor may be asked to take active commitments involving the corporate governance of the company, the management of the sensitive activity, and the protection of the sensitive information and data collected through his activity. In some cases, in significative transactions, the French government can also condition their authorisation to the investor taking active industrial measures in favour of employment, development of the sites, R&D efforts, continued investment in the company, participation in the development of the French ecosystem, etc.

In addition, the right to control certain business activities is exclusively reserved for French and European investors: insurance companies; financial institutions; press companies; entities involved in the manufacturing of war materials; publications dedicated to young people; the audiovisual sector; the air transport sector; and investment concerning ship ownership.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

Private equity is a technical and fairly long process that is generally conducted by an outside counsel in order to perform due diligence. Although red-flag reports are common, the timeframe of the transaction and scope remain similar to any other transaction.

Private equity investors tend to focus more on standalone risks to ascertain the target's autonomous status and possible resale without having to receive third-party approvals.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Over the last few years, France has built an extensive set of regulations to fight against bribery and corruption. These new measures inevitably impact private equity, in particular due to a stricter regulatory framework and increased penalties.

Following on the footsteps of the FCPA or the UKBA, France has also adopted an anti-corruption legislation known as the Sapin II Law (Law No. 2016-1691).

Recently, in order to transpose EU Directive 20158/849 dated May 20th, 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, France implemented legislation providing for a new duty to declare the ultimate beneficial owners of all non-listed corporate entities registered in France.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Generally, the portfolio companies are Limited Liability Companies. On the contrary, if an unlimited company is preferred, the shareholders' liability will be strengthened.

In addition, as explained in question 3.6, a private equity investor may be held liable if the damage is the result of its own mismanagement. However, portfolio companies may not theoretically be held liable for the liabilities of another portfolio company.

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11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Legislative measures recently taken in France and the healthier economic trend and occurrence of certain events (Brexit), will certainly favour France in becoming an important player in the private equity market.

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Germany

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

As Germany is a well-developed and sophisticated private equity market, one sees all kinds of transaction types that are typically found in other mature markets. While the straightforward sale or acquisition of all, or the majority of, share capital or assets of a company is the predominant transaction type, minority investments in (publicly listed) companies, private equity-backed takeovers of publicly listed companies, joint ventures, distressed acquisitions as well as debt-to-equity swaps, often in some part debt-financed, can also be regularly seen in the market place.

Market conditions are outstanding and are at pre-2008 levels. We saw in the last 12 months again a very strong deal-flow across all market segments. More and more, the transactions are covered by Warranty & Indemnity insurances ("W&I insurance"), which has developed into a mainstream product in the German market. While it took a long way for this product to finally succeed (the first W&I insurance was provided in the German market in 2002, advised by the author), it is now accessible at terms that make it attractive not only for private equity players, but rather for all kinds of buyers and sellers.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Germany has a large pool of mature, medium-sized companies that are often (worldwide) market leaders in their area (the "German Mittelstand"), plus a vivid start-up scene, i.e., the number of potential targets for private equity is larger than in any other European market. Combine this with a reliable and educated legal system, the availability of debt for leverage buy-outs and a capital market that may build the bridge for an exit scenario and you have what makes Germany an attractive market place. The general perception towards private equity, especially among the owners of medium-sized companies, is what held the market back in comparison to, e.g., the UK market. But this has also improved in recent years and nowadays even the shareholders of medium-sized (family) companies have set aside their reservations.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

2019 will continue to again be a very good year for private equity transactions; probably not as good as 2018, but still a very good year. Some caution is, however, justified due to the uncertain political landscape and the increasing worldwide trade tension. We have already seen in the last 12 months that this has resulted in a small uptick in insolvencies, which we expect to continue over the next 12–24 months. While this uptick in insolvencies need not mean that the number of private equity transactions as a whole will significantly decrease, it does and will have an impact on valuations and on the attractiveness of cyclical businesses for potential buyers.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

The acquisition structure is influenced by tax considerations of the investor(s), financing requirements, the potential exit scenario, liability considerations and other aspects. Most typically, one sees a non-German TopCo (often Luxembourg-based), which holds a German AcquiCo, which, in turn, then acquires the German target, mostly being a German HoldCo.

These structures are well-developed and can mostly be seen in the market. Minority or joint investments are rather exceptional structures and are mostly contingent on the characteristics of the respective target.

2.2 What are the main drivers for these acquisition structures?

See the answer to question 2.1 above.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

The structuring of the equity depends on the chosen acquisition structure. In a typical scenario with a non-German HoldCo and a German AcquiCo, the equity of the German AcquiCo consists of ordinary equity, sometimes coupled with a shareholder loan given

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by the non-German HoldCo or preferred shares in the German AcquiCo to mirror equivalent instruments at the non-German HoldCo level. Typically, at the non-German HoldCo, you will then find ordinary shares, hybrid instruments such as preferred shares or shareholder loans, as well as preferred distribution rights in certain scenarios.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Yes, as minority positions are usually not financed by external (bank) debt, but rather by pure equity. This may simplify the acquisition structure. On the other side, the investor must then pay due consideration as to how an exit can be achieved and structured, aside from the exit considerations of the main shareholder.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Generally, management is allocated a share of 10% in the acquisition structure, in smaller (VC type of) transactions also up to 20%.

One sees good leaver, bad leaver and vesting provisions most typically structured in such a way that a certain part of the equity vests over a certain period of time and with an option for the company/investor to purchase the equity of the manager in case of departure at a certain price, which depends on whether the manager is a good or bad leaver.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Good leaver scenarios are usually the termination of the service relationship by the company without cause, the expiration of a service agreement without the company offering an extension on at least equivalent terms to the manager, and illness of a manager. All other reasons would then typically (depending on the bargaining power of the parties) qualify as bad leaver events.

One has to keep in mind, however, that the economically desired result may conflict with the actual taxation of the managers, in particular given the fact that the German tax authorities had taken a more rigid stance concerning some particular features in management equity programmes ("MEPs"). The good thing is, however, that the German Federal Fiscal Court (the highest tax court in Germany) has ruled against the more rigid stance of the tax authorities and has thus provided some certainty on the beneficial tax treatment of certain features of MEPs.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

The governance arrangements depend in part on the legal form of the target and of the other companies in the acquisition structure. Assuming the most typical case of a German AcquiCo and the German target both have the legal form of a limited liability company (GmbH) and less than 500 employees, one will typically find that some or all of the top target management assume the role of a managing director of the target, advised and overseen by a voluntary advisory board, with the management of the German AcquiCo then usually consisting of appointees of the investor and in some cases the CEO of the target.

The management of the target company (and any company below it) would need to follow a pre-defined set of rules of procedure, which typically require that the management seeks the prior consent of the shareholders or of the advisory board in case important measures are concerned (the list of important measures is implemented on a case-by-case basis and largely depends on the characteristics of the target (group)). These rules of procedure, and the stipulation of (voluntary) advisory boards in the structure, which have information and consent rights and the right to remove and appoint the management, are the most relevant governance rights for the investor to exercise "control" also on the operating level.

Again, tax and other considerations (e.g., ERISA) of the specific investor need to be observed, in particular as it concerns which rights are ultimately granted, who shall be sent as appointee of the fund into the relevant boards, and which operating decisions ultimately require investor (or shareholder/board) consent.

Furthermore, in cases where certain employee thresholds are surpassed, co-determination rights of employees need to be observed. In practice this is much less of an issue as it first may sound to a non-German investor and there are ways to address and mitigate these concerns.

Where and to what extent such structures need to be disclosed depends on how they have been implemented (e.g., articles of association *versus* by-laws) and on some target specific facts. As a rule, it is achievable that no detailed disclosure needs to occur.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Yes, they do; however, not by virtue of law but by the implementation of the measures as described above. Usually the list of veto rights is rather detailed, but one has to keep in mind that the investor neither wants to assume the role of a factual-manager (e.g., with regard to liability in insolvency scenarios), nor create a tax presence in Germany by virtue of its too narrowly defined consent rights.

In case of a minority position, the veto rights are weaker and usually only provide protection as it concerns key aspects such as structural measures that affect the target group as a whole, exit scenarios (details are usually very specific), capital increases, and related party transactions.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

Besides the risks referred to above, veto arrangements are, in general terms, only relevant as they concern the relationship between manager and investor, but do not invalidate actions which the manager may take *vis-à-vis* third parties in violation of such veto arrangements (save for certain exceptions). Hence, the hurdle for qualifying veto arrangements between the investor and managers as

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invalid is rather high and mostly relates to circumstances which invalidate any other contractual arrangements as well (e.g., violation of general principles of law).

This is, however, a rather theoretical discussion, as investors will usually ask for fewer veto rights than what would be legally possible in order to avoid the risk of being treated as a "factual manager" and any potential negative tax consequences.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

The rights and obligations of shareholders among each other are not extensive and courts have generally followed the concept that is expressed by law, i.e., that shareholders are free to agree on the rights and obligations that govern their relationship in the respective corporate documents. The nuances depend on the legal form in question and whether the target company has a small, more personalised investor base *versus* a diverse, large investor base in the case of a publicly listed company.

As a general rule of thumb, German law requires that structural measures such as mergers and capital increases require a majority of 75% of the votes. If the investor achieves these thresholds on its own, then the investor owes no further duties to the minority/management shareholders, unless stipulated in the articles differently or the minority/management shareholders would be able to show that the respective decision was taken to intentionally harm them – a rather high standard. But again, variances exist depending on the legal form in question.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Germany accepts that contractual agreements between two or more parties are governed by laws of jurisdictions other than Germany as long as these do not conflict with the *ordre public*, which is a pretty high threshold. The same applies to the applicable venue. However, one has to observe certain formalities in order to have a valid venue and choice of law provision. While non-compete and non-solicit provisions are generally permissible and enforceable, one has to be very careful in their drafting, as an over-excessive provision can make the entire provision invalid.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

Besides the tax considerations referred to above, there are limitations on the maximum number of board positions someone can hold in a German stock corporation. Furthermore, German stock corporations have a two-tier board system and one and the same person cannot be part of the management board as well as of the supervisory board (the latter is supposed to oversee and control the management board). The same principle applies to voluntarily established boards that exercise a control function over management.

More importantly, assuming a position as a manager or supervisory/advisory board member entails the risks of violating the fiduciary duties that come along with such a position, and while Germany has also enacted a business judgment rule, a concept protecting managers and board members while exercising their duties, German courts tend to review board actions more and more critically and demand that companies, in fact, pursue former or current board members and managers for alleged misbehaviour.

If an instance of misbehaviour (which can vary from an uninformed business decision to personal entrenchment) is found, the respective manager and board member is then personally liable for all damages caused by it. However, the (often difficult) burden of proof lies with the company.

In order to mitigate these potential risks, D&O insurances are usually sought for managers, board members and (other) nominees. Further, private equity investors try to avoid that nominees assume manager positions, but rather take on advisory board functions.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Although it may sound surprising, reality shows that this is rather a theoretical problem and is, in practice, much less of an issue than expected. Firstly, because nominees of private equity investors would usually not assume a manager position (where one has the issue of a statutory non-compete obligation for managers) for the reasons described above, but rather become a member of a supervisory or advisory board, where they are usually not under a non-compete obligation and exercise only negative control and are hence much less exposed to liability risks. Secondly, all that German law usually (variances depend again on the legal form in question and what the corporate documents say about it) demands from a member of an advisory board or supervisory board is that he acts in the best interest of the company on whose board he is serving, and hence the interests are usually aligned with that of the private equity investor. Lastly, the burden of proof of a violation of the duties of the board member lies with the company and such burden of proof is usually hard to meet in practice.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

Regulatory approvals may be required if the transaction and the involved parties are of a certain size so that antitrust clearance is required, or the target operates in certain industries of particular importance to Germany, such as media or defence (in which case special clearance in addition to antitrust clearance is required). Except for extraordinary cases, the regulatory approval process usually only takes around one month and can be conducted between signing and closing.

More time-consuming are certain aspects which diligent buyers find in other jurisdictions as well, i.e., the due diligence process, negotiation of appropriate transaction documents and, if needed, the arrangement of financing. Germany is, however, a sophisticated market with experienced players and hence these topics can usually

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be dealt with in a timeframe of two to four months (and one also still sees transactions that are completed within two weeks only, although this is rather exceptional).

4.2 Have there been any discernible trends in transaction terms over recent years?

Within the last year and the time of this year, the private equity market in Germany has risen strongly overall. This development is mainly driven by an increase of targets in the market and the availability of bank financings at very favourable conditions. Further, we saw many buy-out transactions in the German mid-cap market segment (the "German *Mittelstand*") – this market segment is increasingly focused on by private equity investors. In addition, many funds are currently very rich on cash and are facing substantial pressure to invest. Beyond that, an increasing trend is that W&I insurance has been seen in many transactions. A W&I insurance takes over (certain) risks associated with the warranties and indemnities regularly given by the sellers as part of the purchase agreements.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Public-to-private transactions require a different tool-set than privately negotiated transactions and investors need to be aware of that. We have advised on one of the very few public-to-privates that occurred in the German market in the last few years and observed first-hand how surprising the legal set-up for this kind of transaction in Germany is for investors, particular for Anglo-American investors.

The challenges can be broadly classified into the following categories: (1) availability of information for due diligence; (2) seeking support by the management of the target and certain shareholders; (3) the acquisition process of shares including the tender offer; (4) ensuring the financing, in particular in light of the strict financial assistance system that applies to a German stock corporation; (5) ensuring the exercise of control and access to the cash flow of the target via domination and profit-and-loss pooling agreements; and (6) conducting a squeeze-out of minority shareholders to the extent the requirements are met.

As each of these steps requires an in-depth analysis of the applicable legal regime in Germany, broad and general statements do cause harm here and interested investors are better advised to seek early legal guidance (before the first share in the target is acquired) if they intend to do a public-to-private transaction. Finally, there is just one more general remark: despite the peculiar legal setting in Germany, public-to-privates are possible if investors are willing to educate themselves and are patient.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

Typical deal protections include business combination agreements between the bidder and the target and irrevocable undertakings by major shareholders. In the business combination agreements, one would then find provisions concerning competing bids, break-up fees and other commonly known provisions.

Due consideration must be given, however, on how the business combination agreement is drafted, as courts have more and more challenged agreements that restrict the target (and its boards) in dealings with potential competing bids.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

In the case of an acquisition of a privately-held company, it is typically either a locked-box-based or a closing accounts-based purchase price, sometimes coupled with earn-out provisions and vendor loans. Also, reinvestments by sellers are seen regularly. In case of a publicly listed target, the consideration is usually a straight-forward cash purchase price; a consideration in the form of an exchange offer is rather exceptional.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

The general rule is that private equity sellers offer almost no warranties/indemnities, as they otherwise cannot show a clear exit to their investors. This general rule has, however, been more and more contested and nowadays one sees structures where either a warranty insurance bridges the gap between the offered and sought protection of buyers, or private equity sellers accept to grant a greater warranty/indemnity package to the buyer if recourse for potential claims can only be sought by raising claims to an escrow account that is funded by a relatively small portion of the purchase price.

Where management is concerned, one sees that they either participate in the same warranty/indemnity package granted by the selling private equity investor, or give warranties and indemnity to a greater extent, in particular in cases where they re-invest their funds into a new structure set up by the buyer.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

The standard package consists of no leakage covenants and guaranties (in very general terms, guaranties are the German equivalent to warranties), a title and authority guarantee and a standard financial statement guarantee. In case it is absolutely required to make a deal happen and the liability of the seller is capped at a small portion of the purchase price and with recourse for potential claims being limited to an escrow or similar account, then one also sees a more standard approach, with detailed ordinary business conduct covenants, standard guarantees for matters such as employment, litigation, compliance with law, real estate and finance and a tax indemnity for past tax periods.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Yes, W&I insurance is now a commonly used instrument in the German market, in particular in the private equity context (see also

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above). Excluded from the "typical" W&I insurance package are known risks or statements where the due diligence exercise has been weak. The competition among W&I insurance providers is currently so high that even insurance packages with no or very low deductibles are being offered. The typical costs for such a product depend on (i) the deductible, and (ii) the amount for which insurance coverage is sought, but as a rule of thumb, it is somewhere around 0.5 to 1%, with a minimum insurance premium of usually EUR 100,000.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

The liability concept is usually narrowed both in terms of time and money. The parties usually foresee that standard breach of covenant or guaranty or indemnity claims can only be raised for a relatively short period of time after closing, whereas claims for title or no leakage have a longer statute of limitation. It is then also provided that the liability of the seller for these standard claims is capped at a relatively low percentage of the purchase price (often with *de minimis* and threshold/basket concepts reducing the exposure of the seller further), with recourse often only being available to a certain escrow or similar account funded out of the purchase price (and the terms of which usually match the statute of limitations and liability thresholds). More fundamental claims, such as claims for a breach of the title or no leakage guarantee or covenant, are then usually capped at the purchase price.

By operation of law, the entire liability concept becomes null and void in case of an intentional misconduct by the seller, and this is often repeated (while not necessary) in the transaction documents as well.

One can see in the market that warranties are only given by the (re-investing) management team, subject to clearly defined liability limitation or W&I solutions, whereas the private equity seller then only assumes warranties as to title, no authority and no leakage.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Yes, escrow accounts are usually provided for, especially if no warranty insurance has been concluded.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

It depends on what is demanded by the seller, but the most common instrument is the so-called equity commitment letter issued by the fund itself or a similar entity. The details of such letters then vary on a case-by-case basis, depending on what the seller demands and what the standard practice of the fund is. Usually, sellers are granted a right to claim funding from the fund into the acquisition structure.

Where the availability of debt financing is concerned, the buyer typically has to show to the seller some form of debt commitment letters, which may provide for a hard debt commitment by the financing banks.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

No, these clauses are rather uncommon in the German market, as transaction security is a very high parameter for sellers, and such reverse break fees, coupled with the walk-away right of the buyer, result in weakened transaction security for the seller.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

IPOs usually do not allow for a full, immediate exit by the private equity seller, as lock-up commitments may need to be given by existing shareholders. Even after lapse of these commitments, a sale of a substantial amount of (remaining) shares may negatively impact the share price and may raise questions about the prospects of the company (unless, e.g., such strategy is communicated via the prospectus).

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

It depends on the respective case at hand, but lock-ups for a period of six to nine months are not uncommon.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Dual-track proceedings can be seen in Germany, particularly for large-cap transactions and when the IPO environment is favourable. Companies are frequently exited, however, via a sale and the IPO road is abolished rather late in the process in order to continue to put pressure on the buyers in terms of pricing.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Debt financing is predominantly provided by financial institutions in the form of acquisition finance, sometimes combined with mezzanine financing provided by special mezzanine capital providers. In larger transactions, one also sees bond financing and debt fund financing, but usually then governed by English law. The appetite for acquisition-related financing is currently healthy in the German market. However, due to the easy availability of debt financing by financial institutions, the need for mezzanine capital is currently very limited and the market for bond financings has dried up to a large extent.

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8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

In order to provide for a debt-push down, one typically needs to seek a profit-and-loss pooling and domination agreement between the borrower and the OpCos (or a chain of such agreements in the structure). While this is a rather standard agreement and easy to get in case of an acquisition of all shares outstanding of the target, it may become very challenging if outside shareholders with a stake of more than 25% are involved. Without such an agreement, the granting of upstream loans and guarantees may become a real challenge.

As already addressed in question 5.1 above, the legal restrictions on financial assistance by a German stock corporation have a significant impact on the structure of debt financing.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

As already indicated, debt financing provided by debt funds has significantly grown in recent years. Nowadays, debt funds even look at smaller transactions, where the debt funding ticket is only EUR 10 million and the documentation (and the governing law) is in German.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Germany has enacted, like many European countries, interest barrier rules which limit the amount of interest that can be offset in the profit-and-loss statement for tax purposes. Another key topic is to structure the transaction in such a way that the private equity fund and its personnel do not become tax resident in Germany, simply by the way consent rights are structured or board rights are exercised.

Off-shore structures are not uncommon; however, these are implemented in the structure of a private equity fund way above a German AcquiCo or HoldCo and are therefore not a feature of the German private equity market.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

A key aspect is that management is being granted "real" equity from the start onwards, as German tax laws differentiate greatly between gain that is received by a manager in return for his invested equity *vs.* gain received as consideration for his respective work services. To qualify as capital gain, various factors must be considered, with one being that the manager has in fact acquired economic and legal ownership of shares in the acquisition structure at arm's length terms.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

As already stressed before, the key aspect is to make sure that any gains received from the sale of such shares qualify as capital gains.

If the management considers rolling over part of their investment, it should be done in such a way that the roll-over does not qualify as a realisation event (on which taxes must be paid), but rather as a tax-neutral roll-over of existing equity in the old structure into new equity of the new structure. This can be achieved if certain steps and conditions are observed.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

The tax treatment of management participation structures underwent significant changes in the recent past. As described in question 9.3 above, the German Federal Fiscal Court ruled that gains resulting from a management participation are, subject to certain conditions being met, to be qualified as capital gains and eventually even as non-taxable capital gains. See also above.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

Just recently, a new law has been enacted that is of relevance for every investor in the dental medical clinics/practice space, as it restricts the market share investor-owned groups can have. While the details of such law turned out to be not as bad as some might have feared, it clearly shows that private equity investments into the health segment are more closely monitored by politicians and the public arena than had been previously.

While not being a regulatory initiative yet, ESG topics are becoming more and more important for private equity funds and their portfolio companies, as institutional investors push for the implementation of respective reporting and monitoring.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

In general, one can say that there are no laws that specifically address, or discriminate, private equity transactions, and this is one of the reasons why Germany offers a rather safe legal system for these kinds of transactions.

We do see, however, that certain areas of public concern or interest impose restrictions depending on the identity of the buyer/investor, e.g., in case of investments into relevant industries or, as mentioned above, in the dental market.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

Due diligence is usually rather detailed, covering all relevant legal aspects of the target including contracts, compliance with law, corporate measures, real estate, employment, etc. It is usually done in a four to six-week timeframe, depending on how well prepared

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and committed the seller is and how many resources the buyer devotes to it. In highly urgent cases, it can also be done within a two-week time frame, but then certain areas are usually carved out or very high materiality thresholds are applied.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Yes, nowadays compliance is part of the usual due diligence exercise of a private equity investor.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

While such a liability may in theory be possible, in practice this does not become an issue, as it can be avoided by the correct structuring of the transaction. The same applies for cross-liability among portfolio companies.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Most of the relevant factors have already been addressed in the above.

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BUB MEMMINGER & PARTNER

Our commercial law firm was founded in March 2019 as a result of the merger of the business division headed by Prof. Dr. Wolf-Rüdiger Bub of the renowned law firm Bub Gauweiler & Partner and the transaction boutique Memminger, founded by Dr. Peter Memminger. Together, we combine expert knowledge from the fields of litigation, transactions and trusted advisory.

We are a nationally and internationally recognised team of highly renowned litigation, M&A and corporate lawyers. We advise on complex corporate disputes and their avoidance, on corporate transactions with a special focus on M&A and private equity and are valued "trusted advisors" for board members, family offices and high-net-worth individuals in all legal matters. Our founding partners have more than 20–40 years of professional experience in their specialist disciplines and are highly recommended and awarded by all relevant specialist media.

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Hong Kong

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

The focus of a large proportion of private equity transactions involving Hong Kong are investments relating to Mainland China businesses. There is a particular, but not exclusive, focus on tech (including FinTech). Private equity houses in Hong Kong also use Hong Kong as a base for transactions throughout the Asia Pacific region (including South East Asia and Australia).

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Innovation and sheer entrepreneurship in Mainland China continue to provide investment opportunities for private equity. As of mid-2018, Hong Kong's private equity players managed to raise a total of US$152 billion, accounting for approximately 16% of the total capital under management in Asia.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

We expect private equity transactions activity to continue to be strong in the next 12 months, although perhaps at a more tempered pace due to uncertainties around US-China trade tensions and increasing interest rates. In the longer term, we see Hong Kong continuing to develop its place as a private equity centre in Asia. Steps being taken, such as amendments to tax exemptions for private equity funds, (see question 9.4) will make it easier for private equity firms to carry out meaningful activities in Hong Kong from a taxation perspective and in addition, the Hong Kong government is considering introducing a new limited partnership regime which would provide private equity funds with further choice in terms of fund structures.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Private equity investors typically utilise an off-shore holding company whose shares are held by the private equity investor and management, or an off-shore limited liability partnership.

Investments in Mainland China which are anticipating an IPO exit will often use an off-shore (e.g. Cayman) bid vehicle which can then be listed in Hong Kong or another financial centre.

2.2 What are the main drivers for these acquisition structures?

Tax efficiency and flexibility are the main drivers for the use of off-shore holding companies and limited liability partnerships.

The use of an off-shore BidCo for PRC businesses is driven by the ease of listing those vehicles and the greater perceived certainty of management control that off-shore structures may have.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

Management equity would usually vest over a period (three to five years, depending on the business) or on an exit, subject to "good leaver/bad leaver" provisions and may have limited voting rights. Institutional investors would typically acquire ordinary shares, but may be subject to transfer restrictions or drag-along provisions. Carried interest is often structured as an earn-out or as a contribution to the consideration for additional shares.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

A minority private equity investor would usually seek minority shareholder protections, including anti-dilution rights. They may also seek special exit rights (e.g. a right to tag along or a right to put their shares) as well as rights to ensure access to information about the business.

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2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Although this will vary from transaction to transaction, the typical range of equity allocated to the management can range around 10%–15%. Management equity would usually vest over a period of three to five years (depending on the nature and maturity of the business). Management equity would typically be subject to compulsory acquisition at costs/book value in a bad leaver scenario, but at fair market value in a good leaver scenario.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Circumstances in which a management equity holder may be treated as a bad leaver include leaving the company voluntarily and in breach of his contract. Examples of a good leaver include death, disability and termination without cause. A good leaver can also be simply defined as a holder which is not a bad leaver.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

Where there is more than one shareholder, the governance arrangements will typically be set out in a shareholders' agreement (or partnership agreement if a limited liability partnership structure is used). These will include minority protections and veto rights as well as provisions in respect of board representation and reserved matters.

They would typically not be publicly available.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Yes, they do typically enjoy veto protections, including issuance of further equity or incurring significant debt and changes to the nature of the business. More significant minority shareholders may also seek veto rights in relation to business plans and budgets and expenditures over a specified threshold.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

Directors owe a fiduciary duty to exercise their rights as directors (including voting) in the interests of the company. This duty may limit their ability to exercise veto rights solely in the interests of their nominating shareholder.

No such duties exist for shareholders, who are free to exercise their veto rights as they choose.

For this reason, certain veto rights may be allocated to shareholders (rather than directors).

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

As a general position, there are no such duties owed by or to the private equity investor, although nominee directors must exercise their powers in the interests of the company (and not merely their nominating shareholder).

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

There is no general limitation or restriction on shareholder agreements and they are widely utilised in Hong Kong.

There are no particular governing law requirements in Hong Kong. However, where all (or substantially all) of the subject matter of the agreement (including the parties) are based in Mainland China, it may be a requirement of PRC law that the agreement be governed by PRC law.

Broad-based competition law was introduced into Hong Kong in 2014. As a result, non-compete provisions in shareholder agreements must meet the same standards as in other commercial contracts and are only valid to the extent that they are reasonably necessary to protect the legitimate business interests of the party imposing the restraint.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

There are few restrictions on a person being a director of a Hong Kong company. The person must be at least 18 and cannot be an undischarged bankrupt or subject to a disqualification order.

The key risks for nominee directors include: liability for a breach of their duty as a director; or liability for insolvent trading. There is also potential liability for false or misleading statements for directors involved in authorising a prospectus (i.e. on exit).

Investors who nominate directors would typically have no liability exposure (assuming they do so in accordance with the agreed requirements). However, investors need to be wary of acting as "shadow directors" (where the board or the company is accustomed to acting in accordance with the investor's instructions). Shadow directors will be considered to be directors and, therefore, are exposed to the same liabilities as directors.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

They must disclose any such conflicts and cannot participate in

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decisions where there is a conflict unless the Articles of Association permit them to do so.

Where the Articles permit a director to participate in a vote, notwithstanding the conflict, the director is not discharged from his or her obligation to act in the interests of the company.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

There are few non-sector-specific issues which have an impact on transaction timing if the underlying business is in Hong Kong. There is generally no need for competition or other regulatory approval, unless required by sector-specific regulation (e.g. financial services or telecoms sectors in Hong Kong).

However, transactions involving targets in Mainland China may face significant regulatory approval requirements, relating to both foreign ownership, competition issues and sector-specific requirements.

4.2 Have there been any discernible trends in transaction terms over recent years?

The use of warranty and indemnity insurance is increasingly popular in private equity transactions (which is a continuing trend).

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Such transactions will be subject to the Hong Kong Takeovers Code (the "Code").

Hong Kong listed companies are frequently controlled by a single controlling shareholder or family. This means that it is imperative to have the support of that shareholder. Typically, a transaction will commence with an agreement with the controlling shareholder which will immediately trigger an obligation to make a follow-on offer. The Code requires all shareholders to be treated equally and the offer must be on the same or better terms than the terms of the private transaction with the controlling shareholder.

Takeover offers cannot be subject to finance and therefore finance needs to be in place (if required) prior to commencing the offer.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

Break fees (and inducement fees) are permitted in Hong Kong. However, the Code requires that it be *de minimis* (which the Code suggests is normally no more than 1% of the offer value) and the target company's Board and its financial adviser must confirm to the Takeovers Executive that the fee is in the best interests of the shareholders. It must be fully disclosed.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

Private equity investors on the sell-side prefer a cash consideration transaction and tend to use both completion account post-completion adjustment mechanisms and locked box mechanisms. The choice tends to be driven by the general preference of the private equity house. They may look to mechanisms such as warranty and indemnity insurance, rather than retained payments or escrow accounts, to provide comfort to purchasers in respect of future claims.

Private equity investors on the buy-side commonly offer cash consideration. They may also offer management equity in the acquiring entity to allow them to roll-over part or all of their stake.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

Warranty packages offered by private equity sellers are usually extremely limited (e.g. title, capacity and authority only), unless the warranties are fully backed by warranty and indemnity insurance (in which case a much fuller set of warranties may be given).

Management with a significant stake will be expected to give extensive warranties.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

There will typically be a set of pre-completion restraints to ensure that there are no material changes to the business and no leakage of value prior to completion.

Members of the management team may give non-compete undertakings for a period after completion.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Warranty and indemnity insurance is increasingly popular in Hong Kong private equity transactions.

The excess and policy limits will vary depending on the transaction (including the nature of the business and the perceived risk).

Environmental claims and claims in respect of certain PRC (Mainland China) taxes are typically carved out.

The typical cost of such insurance is generally in range of 1%–2% of the policy coverage limit.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Where limited warranties are given (title, capacity and authority), liability will often be capped at the purchase price.

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Where broader warranties are given, private equity sellers' liabilities will be a matter for negotiation and may range from 10%–100% (although that would be unusual). It is increasingly common for the private equity sellers to use warranty and indemnity insurance to manage their risk.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

This is increasingly commonly dealt with via warranty and indemnity insurance.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Bid letters will typically contain a representation that the bidder has sufficient financial resources. Where there is uncertainty, the bidder may be required to provide a bank commitment letter.

Bank commitment letters are usually not legally enforceable.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

No. These are not common.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

A private equity seller and the target company's directors may face significant liability for misstatements in a prospectus.

The process can be lengthy and tedious and the company will likely be asked a series of questions by the listing committee and the regulator which can have a significant impact on the timetable.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

A controlling shareholder must maintain the shareholding stated to be held by it in the prospectus for six months after listing (except to the extent that the prospectus stated that the shares were offered for sale in the prospectus). That controlling shareholder must not sell shares for a further six months if the sale would result in it no longer being the controlling shareholder.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Dual-track processes are not common in Hong Kong (although they do occur). This is likely because of the costs involved and the fact that sellers appear to determine clearly, and early, which approach is likely to result in the better price outcome.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Traditional bank (leveraged) debt is the most common source of debt finance.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

There is a prohibition on a company giving "financial assistance" and this can impact on the use of certain financial arrangements (including the use of the target company's assets to secure borrowings to be used to acquire shares). There is a "whitewash" procedure available.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

We have seen the amount of leverage employed in private equity transactions increase from 2018. Banks in Asia remain eager to support private equity buyouts and the growth of institutional participation in Asian leveraged loans is adding another pool of liquidity that private equity firms can tap into in order to finance deals.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

There are very limited Hong Kong tax considerations for private equity investors. However, Hong Kong frequently sees off-shore structures being used.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

These mechanisms are rarely used in Hong Kong.

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9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

There are no capital gains or similar tax considerations in Hong Kong. However, non-Hong Kong investors are frequently concerned with these issues in the jurisdictions in which they are tax-resident.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

In 2015, the most significant legislative reform in Hong Kong affecting private equity funds was the extension of the profits tax exemption for off-shore funds to cover certain private equity funds. The amendments were aimed at boosting Hong Kong's private equity fund industry by attracting more off-shore funds.

In 2019, the Hong Kong government has amended the tax exemption for private equity to make it easier for private equity firms to carry out meaningful activities in Hong Kong without triggering permanent establishment from a taxation perspective. The new profits tax exemption regime for private equity came into effect on 1 April 2019, which (i) allows the exemption to apply to a fund for which its central management and control of the fund is exercised in or outside Hong Kong; (ii) allows the exemption to apply to a fund's investments in both Hong Kong and non-Hong Kong companies; and (iii) removes the tainting features of the old regime, i.e. the tax exemption can now be applied to the qualifying transactions of a fund even if it includes other non-qualifying transactions.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

In relation to potential IPO exits, the Stock Exchange of Hong Kong published new rules in April 2018 to permit listings of biotech issuers and listings of companies with weighted voting rights structures.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

Private equity transactions are not subject to any particular enhanced scrutiny. There is no broad-based foreign investment restriction in Hong Kong based on national security or national interest considerations, although restrictions on foreign investment exist in certain industries such as banking, television and sound broadcasting and civil aviation.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

A private equity investor may conduct legal due diligence over a more compressed time period compared to a trade buyer. There is no "standard" materiality threshold or scope for legal due diligence, as this will be determined by the nature of the business and the perceived risks.

Typically, private equity investors will require an "exceptions only" due diligence report.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Yes. Whilst there are usually significant contractual warranties around compliance in this area, it is increasingly a significant area of diligence and parties will not be satisfied relying only on contractual protections. Where issues are identified they can have a material impact on the transaction timetable.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Hong Kong courts will typically respect the "corporate veil" and it is unlikely that they would hold investors liable for the acts of the portfolio companies or hold one portfolio company liable for the acts of another.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Hong Kong is a jurisdiction which seeks to encourage investment, including from off-shore. It has a highly developed common law legal system and sophisticated financial sector.

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Chin is the sole winner of the Hong Kong M&A category of the Client Choice Awards 2019. Chin is listed as a Recognised Practitioner in *Chambers and Partners Global* for Corporate/M&A: Hong Kong-based (International Firms) – China.

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Joshua is qualified to practise in Hong Kong and Australia.

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Hungary

Dr. Márton Kovács

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

The business environment for private equity (PE) transactions in Hungary is favourable. Central and Eastern Europe (CEE) is trending upwards, the domestic economy is growing and financing is cheap and readily available. Thus, Hungary is a well-liked target of international PE investment companies interested in share and asset deals. Hungary closely follows Poland, Latvia and Romania as the most-frequented jurisdiction for PE investments in the region.

Venture capital (VC) markets in particular are emerging and there are a host of domestic funds specialised in small-scale investments that are financed from EU resources (funds of funds) and by PE investors. Such public funding is generally available on the condition of receiving private funding which attracts PE investors.

Riding the wave of EU funds and the Hungarian Government initiatives providing strong support for VC investments, the past few years saw the rise of seed and start-up investments providing capital for the early phases of product development and distribution. This is shown by the fact that Hungary saw the largest amount of companies receiving PE investments in 2017 (104) accounting for 40% of the total number of companies in the entire CEE region despite the fact that the volume of investments make up only 5% of the region's share.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Hungary has already proven to be a credible and growing market for international and domestic players. The growth potential is still great in CEE and Hungary ranks among the top four countries in PE activity. Hungary, unlike more mature Western European markets, offers opportunities for off-market deals and reasonable pricing with an economy growing at an average of more than 3%. In addition, the rising domestic consumption allows investors to maximise their profits within the region.

The availability of EU and domestic funds and their attractiveness to PE, the low interest rates and cheap financing possibilities, the booming start-up scene, as well as the Hungarian Government, have many times accentuated the drive to draw in capital to fuel the domestic economy which keeps the interest of experienced PE investors from Europe and, especially, the United States, alive.

Hungary is becoming more attractive for investors from new regions, such as China, the Middle East and South Africa. For these third country investors, besides the general business advantages, Hungary offers free access to the EU market.

PE transactions are sometimes inhibited by the relatively small market itself. Dealmakers in Hungary are also keeping an eye on geopolitics focusing on the occurring strains with the EU, a crucial trading partner and investor in the region.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

Since the fundamentals underpinning an active M&A market remain firmly in place for the next year ahead, and the Hungarian GDP is forecast to average more than 3% over the next 12 months, we do not predict significant change in M&A activity this year. Transactional activity is nonetheless expected to grow in the coming years particularly in the segments of agriculture and healthcare providers. For the longer term, we expect that the intensity of M&A activity will be affected by the general global economic slowdown, predicted by many. Although, investors will find many incentives in the Hungarian market in the forthcoming years that can compensate the potentially less favourable economic environment.

Apart from the incentives mentioned above, the new JEREMIE programme, which started in August 2018, will bring HUF 80 billion (approx. EUR 250 million) to Hungary within the next five years from which 150 Hungarian start-up companies will receive funding. Based on experience in recent years, this will most likely attract regional PE investors in the initial and the possible future investment rounds.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

The most common acquisition structure for PE transactions is naturally the acquisition of 100% or the majority of the target's shareholding.

In the VC market, portfolio companies are usually set-up jointly by the founders and the investors to serve as a special purpose vehicle

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for future investment rounds but in case of more mature companies with ongoing product development and market presence, the investor may opt for a share purchase or capital increase in order to keep the brand going.

2.2 What are the main drivers for these acquisition structures?

The main driver for the acquisition structures is to have corporate control over the target and preservation of the investors' rights. In some cases, other considerations, such as tax, have substantial effect on structuring matters.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

The most popular form for PE and VC investments are limited liability companies, namely "*zrts*", i.e. companies limited by shares, or "*kfts*", a company form which issues business quota instead of shares. Business quotas have their share of limitations in terms of flexibility compared to shares, but they are still able to meet the investors' needs in regard to preferential rights associated to the investors' equity interest.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

An investor with minority shareholding interest in general requires much stronger rights attached to its shares or business quota. Such rights embedded into the corporate structure and the underlying contractual arrangements usually take the form of a wide range of preferential rights relating to exit, decision-making, dividends, liquidation, control over the management and key employees.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Transactions vary in this regard, but a typical pool of shares allocated to management members and key employees (hence the term, ESOP or Employer Stock Ownership Programme) ranges from 5%–10%. Vesting under Hungarian law can sometimes be problematic and, especially for VCs, the preferred solution for ensuring management retention is the so-called reverse vesting where the management must divest all or part of their shares if they leave the company or violate the shareholders' agreement (SHA). This is usually ensured by a call option established for the benefit of the investor.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Good/bad leaver conditions are usually negotiated on a case-by-case basis but, in general, a management member is typically considered to be a good leaver if the employment relationship is terminated by mutual consent or unilaterally by the company, unless it is based on reasons attributable to the management member. Good leaver conditions sometimes include long-term health or family issues.

Circumstances under which a management member is considered and sanctioned as a bad leaver are obviously much broader, e.g. management members terminating their employment contract during the early years of the investment or without reasons neither attributable to the portfolio company nor the investor, or committing material breaches of the SHA or their terms of employment.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

Most of the portfolio companies operate as private limited companies (or stock companies, abbreviated as "*zrt.*" in Hungarian) and especially in the VC sector, limited partnerships. Hungarian law enables a great deal of flexibility in terms of corporate governance for both. The three most important governance bodies of Hungarian companies are:

- the shareholders' meeting operating as the fundamental decision-making body (ownership level);
- board of directors or a single director heading the day-to-day business operation (management level); and
- the supervisory board serving as the controller of legitimate operation.

On the ownership level, the investor, especially if a minority, generally retains the most important veto rights in material issues to ensure that fundamental decisions affecting the life of the portfolio company are adopted with due regard to the investor's interests.

On the management level, investors generally require the set-up of a board of directors, if the portfolio company does not have one already, where the investor delegates at least one board member. The board decides in every issue not specifically allocated to the scope of authority of the shareholders' meeting but even then, the board member delegated by the investor usually exercises veto rights in material issues. The board of directors' functions may be allocated to a single management member who replaces the board, but this usually does not serve either parties' interests well and thus it is a rare sight.

On the third level, a supervisory board is operating in most of the portfolio companies which oversee compliance with the relevant laws and internal by-laws of the company.

Corporate documents that are submitted to the court of registration are publicly accessible for anyone but there can be internal regulations and SHAs that remain hidden from the public. The drawback of such private law agreements and non-statutory regulations is that in case of a dispute they can only be enforced in civil court, which may take significant time.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Veto rights on both shareholder and management level are a very common tool for investors, especially investors with minority shareholding, to maintain reasonable control over the operation of the portfolio company. In recent years, *de facto* veto rights started to be replaced by a high quorum required to decide critical issues.

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For example, if the investor holds a 4% share in the portfolio company, then setting a minimum quorum of 96.01% means that no material issues can be decided without the consent of the investor. This is because the Hungarian competition law and the Hungarian Competition Authority (HCA) considers strong veto rights to qualify as a controlling right. If a controlling relationship exists between two or more companies, this may call for the application of strict EU and domestic competition law and result in mandatory pre-notification or even approval to be sought by the parties. In order to avoid these costly and time-consuming procedures, both founders and investors are becoming more careful with incorporating investor rights into the corporate documents.

Veto rights and topics requiring high quorum at the most important decision-making level, the shareholders' meeting, are usually restricted to material issues affecting the core operation of the portfolio company that can range from the most important corporate decisions (merger, transformation, liquidation, annual report) to business operation issues like entering into high-value contracts, taking out loans and licensing intellectual property rights. There is no exhaustive list of veto rights as they are usually subject to negotiation by the investor and the founders or other shareholders.

Similar veto rights exist on a management level (usually a board of directors) where the board member delegated by the investor has the final say in crucial management decisions (ESOP, vesting, key employees, management bonus, etc.).

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

The drawback of veto rights or high quorum provisions incorporated into the corporate documents of portfolio companies stems from the relative nature of such internal regulations compared to proprietary rights that are absolute. Although corporate documents are publicly accessible, veto rights are not listed in the corporate registry that third parties rely on and third parties may presume, in good faith, that a decision adopted by the shareholders or the management is valid and effective, even if they have been adopted contrary to the corporate documents including veto rights.

Further limitation on the effectiveness of such veto arrangements, on either level, is the fact that any decision adopted in violation with the investor's rights must be challenged in court and such court procedures may take a long time, ranging from a couple of months to several years, even if the law provides for an expedited procedure.

These limitations cannot be effectively addressed, and investors simply must accept the associated risks and negotiate other types of insurances, for example, flip-over, call-and-put-options and other rights exercisable in case of serious violation of the SHA and/or the corporate documents.

Also, veto rights in the Articles of Association are hardcore limitations as to the business operation of portfolio companies and as already mentioned above, the HCA sees them as controlling rights under competition law which makes the market players cautious and be more inclined to resort to a softer tool (high quorum) to ensure investor rights.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or vice versa)? If so, how are these typically addressed?

Under Hungarian law, shareholders have a duty towards the portfolio company and not the other shareholders and even then, only to the extent of providing their respective capital contributions. Shareholders' have rights that they can exercise *vis-à-vis* the company itself or the management.

Minority shareholders enjoy special rights pursuant to the corporate laws in regard to convening the shareholders' meeting or appointing an auditor for the investigation of certain business decisions. Furthermore, all shareholders have the right to contest the validity of a resolution of the supreme body, the management or the supervisory board of a company, if the resolution violates legal regulations or the articles of incorporation of the company (with the condition that the shareholder did not approve the given resolution with its vote).

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

The enforceability of SHAs may become problematic and very time-consuming in the case of parties with different nationalities, especially outside the EU. That is why, in practice, SHAs stipulate the governing law and jurisdiction of the country where the portfolio company is seated and it is rather rare that a SHA related to a Hungarian company stipulates foreign law. Commercial arbitration, however, is much more acceptable in high-value deals and it is not uncommon that the parties submit themselves to the jurisdiction of an international arbitration court (ICC, UNCITRAL, etc.) for disputes stemming from the SHA.

The risk of unenforceability is usually addressed in the SHAs by additional insurances for the investors in case of violations, like triggering exit rights at a given return on the investment, flip-over of management or put/call option on shares.

Enforcing non-compete and non-solicitation obligations is especially tricky without a reasonable limitation on the affected geographic region and scope of activity. Investors run a high risk of being unable to enforce such provision against parties or activities on another continent, therefore these undertakings are usually underlined by penalty payment obligations of the infringing party.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

There are standard conditions applicable for all board members (and management in general, altogether called "executive officers") across all companies regardless of nationality and whether they are delegated by an investor or not. These general requirements include being of legal age, having full legal capacity, having no criminal record and not being prohibited by court from being a management member. Special conditions may apply to portfolio companies operating in the financial sector or any other sector that requires professional expertise in certain fields.

Risks and liabilities of board members delegated by an investor are the same as any other board member's: they must perform their management functions representing the company's interests; and they must comply with the internal by-laws as to procuration, decision-making and other regulated areas. But, in fact, investor-delegated members usually have less rights and information related

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to the portfolio company's actual operation compared to the other board members. The information asymmetry affects the position and capability of these board members which, in turn, results in higher business risk for the investor. This is usually addressed in the SHAs through provisions granting the investor-delegated board member immunity to set off the lack of information and actual control over day-to-day operation.

The investors (or any other shareholders or third parties) themselves have no legal risk or liability related to their delegated board members as "delegation" is not a legally regulated issue under Hungarian law. Board members are ultimately appointed by the shareholders regardless of any background deals and the shareholders are not legally liable for the appointment except under extreme circumstances where, for instance, the appointment was in bad faith or qualifies as a crime.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

(i) Depending on the actual transaction, a PE investor may have majority or minority voting rights in the portfolio company In either case, the directors must act all times by force of law in the best interest of the portfolio company which is also in line with the PE investors' interests in the successful and profitable operation of the company so, in practice, potential conflicts of interests of this nature are rare and they are not different from general conflict of interest issues potentially arising between shareholders and management members.

(ii) Directors nominated by the same PE investor are usually not delegated to portfolio companies with competing activities, especially with regard to the small Hungarian market, and it is quite rare for a PE investor to invest in companies competing with each other.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

These issues will very much depend on the industry in which the investment is taking place. In industries like banking, insurance and energy, the transfer of control over a regulated entity is subject to prior regulatory clearance. These clearance proceedings can easily take between one to three months.

Financing is cheap and easily available in Hungary for various PE transactions but data protection issues, especially the GDPR, present frequent headaches for sellers, buyers and investors alike. Portfolio deals involving large databases of personal data, especially if multiple jurisdictions are involved with various regulatory practices, may affect the scheduling or even the feasibility of deals. Unfortunately, such issues may well emerge during the due diligence process by the time the parties have already invested serious resources into preparing the transaction.

4.2 Have there been any discernible trends in transaction terms over recent years?

Transaction terms vary greatly depending on the parties, negotiating skills, sector and the type of transaction (share or asset deal, VC investment, etc.), but one noticeable trend is the more frequent appearance of foreign start-ups in international pitches and as targets for Hungarian VC funds which may be the result of the start-up friendly environment and the cheap funding available.

It is but a minor observation, but worth noting that drag-along and tag-along provisions still consist a part of the regular set of rights in SHAs despite the fact that, according to the common experience and understanding of market players, no drag-along or tag-along right was actually exercised in Hungary in the past decade.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Public-to-private transitions are not common in Hungary due to the relatively low number of listed companies. Pursuant to the Hungarian Capital Market Act, any third party intending to acquire more than 33% (or 25% if no other shareholder has more than 10% in the company) shares in a listed company, a mandatory public takeover bid must be submitted to the Hungarian Central Bank as supervisory authority. At the same time, the takeover must be published and sent to the company as well. Any shareholder may decide to opt-in and sell their shares within a 30–65-day period. Similar rules apply to voluntary takeover bids except for the minimum threshold which means any third party may submit a takeover bid regardless of the volume of affected shares.

Special rules apply to a takeover bid exceeding 90% or shareholders ending up with more than 90% of shares following a public takeover bid process. In such cases, the majority shareholder can squeeze out the minority shareholders at the price quoted in the takeover bid or the amount of equity capital per share, whichever is higher.

Breakthrough provisions may be incorporated into the corporate documents of the listed company to lift certain restrictions applicable to the share transfers.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

Public takeover bids are strictly regulated and there is little room for manoeuvring for PE investors. In their takeover bid, a buyer may reserve the right to withdraw the takeover bid if, pursuant to the declarations of acceptance, the shares to be acquired are less than 50% of the total shares of the listed company.

Other contractual arrangements (like a break fee or reverse break fee) between the seller and buyer may be applicable and enforceable but any arrangement affecting the price must be published along with the takeover bid.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

PE sellers in Hungary prefer the locked box mechanism which enables the fixing of the purchase price at the date of signing of the

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SHA. This pricing method gives more control to the seller over the elaboration of the price and requires an in-depth due diligence on the buyer's side to make proper adjustments before signing the SHA with the fixed price. The advantage for both parties is that the price is fixed and known in advance and the sale process can be much quicker as no closing accounts are necessary.

Following the international trends, the locked-box price setting methodology is slowly replacing the post-closing price adjustment method as the most commonly used tool in M&A transactions.

On the buyers' side, PE investors still prefer the classic buyer-friendly method of price adjustment based on the working capital, debt and cash data of the company. This makes the acquisition process longer and requires more effort from both parties but gives room for the parties to adjust the price based on events that occurred between the signing and the closing date.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

The list of seller warranties and indemnifications are typically the most heavily negotiated set of terms in M&A transactions and PE investors always try to narrow down the scope of warranties to the most prevalent warranties related to legal title and capacity. Met with the buyers' intentions to widen the sellers' scope of liability, an average W&I list usually includes warranties related to good standing, capitalisation, shareholder structure, financial statements, intellectual property, material contracts, taxes and compliance with the applicable laws and regulations.

Post-closing indemnity is often limited to a reasonable period of time (two to five years depending on the associated risks, for example, indemnity for environmental issues usually covers a longer period while tax indemnities are sometimes excluded). Basket thresholds, which mean a certain aggregated amount must be reached before any indemnity is enforced, and caps are also regularly applied.

Seller indemnity is often backed by an escrow typically around 5%–15% of the purchase price from which the buyer may claim the amounts related to any specific breach of the seller's W&I obligations. In the mega-deals, this classic deal structure is currently being transformed slightly by the increasing trend of taking out W&I insurance for the comfort of all parties.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Typical undertakings of a PE seller and its management team include non-competition and non-solicitation obligation for a limited period of time, usually one to three years.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs /exclusions from such insurance policies, and what is the typical cost of such insurance?

Hungarian PE transactions including W&I insurance are still seldom, although it is slowly but steadily spreading in practice. W&I insurance is usually applied in high-value (above EUR 10 million) commercial real estate deals where the insurance premium moves in the range of 0.8%–1.3%, but the market players and the insurance companies are becoming more and more prepared for reducing the sell-side transaction risks by taking out W&I policy.

The Hungarian market is starting to realise the valuable advantages of limiting sell-side risks and having a buy-side policy where the buyer and the insurance company may directly deal with each other without the necessary involvement of the seller committing a warranty breach. Buyers also spare the costs and time related to the retention of the purchase price or an escrow agent as well as post-closing litigation and instead charge their costs on the sellers who are still better off with the low premium rates.

W&I insurance also makes risky transactions more attractive and provide another tool for both sellers and buyers to negotiate the deal.

Usual policy limits include a minimum premium set by most insurers, a *de minimis* or basket threshold and a cap on the risks covered by the insurer as well as the exclusion of such forward-looking and post-closing warranties as reaching a certain turnover or profit level. Existing risks known by the parties, regulatory fines, fraud, corruption, environmental issues and conditions of real estate are also usually excluded.

Premiums are affected by many conditions including depth of due diligence, seller transparency, list and type of warranties, advisor competency, geographic location, etc. As a rule of thumb, premiums usually move between 1%–1.5% of the transaction value but coverage for specific or non-regular risks can be more expensive.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

PE sellers usually negotiate a minimum and maximum threshold for their liability between 10%–20% depending on the type and specific conditions of the given deal and especially the outcome of the due diligence and a time limit of three to five years. Buyers generally try to exclude legal title, capacity and tax warranties from such limitations due to their high importance and the associated risks.

The liability of management teams is either dealt with under the general rules applicable for management liability or capped *pro rata* their shareholding interest.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

PE buyers usually provide bank guarantee, parent guarantee, or an escrow amount for a pre-determined part of the purchase price. The retention of a certain part of the purchase price on part of the buyers is still seen as the best option for buyers but this is becoming less and less frequent due to the current seller-friendly market.

Obtaining securities by PE investors for management liability is not common in Hungary.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Depending on the value of the transaction, the negotiated deal and

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the proportion of equity/debt financing, PE buyers usually provide a comfort letter or a commitment letter on the available equity financing that is usually sufficient for buyers on the relatively small Hungarian market.

As to debt financing, a confirmation letter or mandatory, but conditional, financing offer from banks on the availability of a loan or line of credit, is usually required.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees on the buy-side (break fees on the sell-side) usually do not appear in Hungarian M&A PE deals.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

IPO exits may provide higher returns for PE investors than other exit routes (for example, public equity markets may valuate the company higher than regular buyers) but they also involve several limitations relating to the exit. IPO processes are also costly and time-consuming efforts and investors looking for quick cash may eventually pursue other exits rather than waiting and even then the outcome may be uncertain.

Also, it must be noted that IPO exits are not a common occurrence in Hungary.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

There is no mandatory lock-up period in Hungary for investors before going public. Also, although IPO exits are not a common occurrence in Hungary, in theory, PE shareholders, including angel investors, venture capitalists and other entities investing in the company pre-IPO, would be required to comply with a lock-up period of three to six months after going public to keep the stock prices high.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

As noted above, such exit strategies, where the PE seller is pursuing both an initial public offering and a potential M&A exit are not as common in Hungary as in other European countries or in the US.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Small-cap transactions which make out most of the PE transactions on the Hungarian market are usually financed through equity but for mid-cap and large-cap transactions, cheap debt financing is available due to the Hungarian Central Bank's policy of keeping interest rates low for the past several years.

Hungary's bond market is dominated by government bonds and corporate bond issuance is scarce.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

No special legal requirements or restrictions apply to debt financing of PE transactions.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

Banks operating in Hungary are still offering attractive financing opportunities for PE transactions due to the low interest rates and potential buyers have access to cheap financing for various deals.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Offshore structures are becoming less preferred due to the strict anti-money laundering rules of the EU. Ultimate Beneficial Owners (UBOs) of contracting parties must be identified in various phases of transactions by the parties' legal and financial advisors which makes offshore companies with non-transparent owners less attractive.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Management participation is not that common in Hungary, but whether the sale of shares under a management participation qualifies for a tax-exempt capital gain is a case-by-case decision.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

Since the dividend and capital gains tax form an integral part of the personal income tax regime, such kinds of income paid to a non-resident individual may be subject to personal income tax at 15%, unless the rate is reduced under the applicable tax treaty.

Private person founders or management teams resident in Hungary selling their investment should be aware of the current 15% income tax and 19.5% social contribution (*szociális hozzájárulási adó*) applicable to natural persons realising any income based on the actual profit they make.

In case of foreign investors, the relevant Double Tax Treaty (DTT) can determine tax exemptions or tax relief opportunities.

Rolling over the investment into a new company structure does not involve tax considerations if the volume of shares remains the same.

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9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

A new Act on Social Contribution Tax entered into force in 2019. From 2019, healthcare contribution is replaced by social contribution. Under the previous regulation, a 14% rate was applied for private individuals on their capital gains and dividend income which was increased to 19.5%. The HUF 450,000 tax cap on contribution payment was also increased to HUF 697,320 for 2019.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

In December 2016, the legislator introduced a new regulatory package for the establishment of PE funds which enables an easier set-up of funds and fund managers. Unfortunately, the laws relating to PE and VC funds are still not unequivocal in certain aspects, the application thereof is not clear and the Hungarian regulator's ever-shifting practice makes the Hungarian market sometimes hard for market operators and advisors to work in.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

National security consideration as well as anti-fraud, anti-money laundering and anti-corruption laws do not distinguish between PE investments but certain sectors, especially the financial sector, are under strict scrutiny by the competent authorities.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

Legal due diligence is confined mostly to a red flag type of review in smaller transactions which concentrates on the identification of the most prevalent legal issues (corporate structure, lawful operation, capacity of management, significant contracts, employment issues, intellectual property and real estate property). Such DDs usually take between two and four weeks depending on the availability and quality of the data room and the maturity phase of the portfolio company.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

In line with the international and EU trends, the Hungarian anti-bribery and anti-corruption laws have been becoming stricter in recent years, but we are not aware of any shift in the investors approach to PE transactions.

Anti-bribery and anti-corruption regulations are stricter in various sectors (finance, government) so market players operating within these fields are more affected if involved in PE transactions and compliance is usually checked during the legal and financial due diligence process.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

The Hungarian law does not distinguish between a PE investor shareholder and any other shareholder which means every shareholder is liable for their activities as a shareholder to the same extent. The extent of liability is predominantly established by the company form in which the portfolio company operates. Due to the limited liability nature of the most common company forms (*kft.* and *zrt.*) in PE transactions, the shareholders are, in general, liable up for the obligations of the portfolio company only to the extent of their own capital contribution. Under extreme circumstances, for example, when a shareholder deliberately abuses its limited liability, the limited liability is not applicable but in practice such investor behaviour is basically unprecedented.

Under Hungarian law, a portfolio company will be liable for the liabilities of another portfolio company only if there is a direct link between the unlawful conduct of these companies either through a contract or market behaviour, for example, in case of an illegal merger. Under normal circumstances all portfolio companies, even with overlapping shareholders, will have a stand-alone liability for their own obligations.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

PE investors should be aware of Act LVII of 2018, which entered into force on January 1, 2019 and introduced a national security review for foreign investments in Hungary. For the purposes of the act, any natural person or legal entity registered in a country outside of the EU, EEA or Switzerland is considered a foreign investor. Investors should also be aware of indirect investments of foreign entities, where the foreign entity is the majority controller of a non-foreign investor entity.

Pursuant to the act, a foreign investor may acquire more than 25% (or 10% in case of a listed company) shares in a company registered in Hungary and operating in certain strategic industries if a prenotification is filed to the minister subsequently appointed by the Government about the planned transaction. Strategic industries include the military, financial and public utility and public information security sectors and will be specified later by the Hungarian Government in separate decrees. The minister issues a written resolution about the acceptance or the prohibition of the transaction, the latter only if the transaction violates Hungary's national security interests. The minister's decision can be challenged before court in an expedited procedure.

Non-compliance with the law may result in a fine of HUF 1–10 million depending on whether the infringing party is a legal entity or a natural person.

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From 2003, Márton worked in the real estate and litigation practice group of the Budapest office of Baker & McKenzie. In 2006, he founded his own firm and from January 2017, he became one of the founding partners of HBK Partners. Although his professional experience covers mainly real estate and M&A, he is also proficient in capital markets transactions, having led HBK Partners' capital markets team in all three public takeovers at the Budapest Stock Exchange in 2017 and the listing of Hungary's fourth largest commercial bank in 2019. Further, he has gained unique experience in hotel law, representing various investors *vis-à-vis* global and local hotel operator companies. Márton is also a lecturer in M&A courses of the Budapest Institute of Banking (BIB) and holds workshops for various VC funds and start-up companies.

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Gabor established his own law firm in 2009 and joined KMBK Legal Partnership where he accumulated experience through working for various government agencies and leading Hungarian banks. Gabor teamed up with colleagues from global law firms to represent Hungary against multinational investors before various international arbitration fora, like ICSID in Washington and the PCA in The Hague, in procedures related to energy and telco issues. He provided legal advice on a regular basis to Hungarian agencies and companies in large-scale railroad and waterways development projects in state aid issues.

Gabor joined HBK Partners in September 2018, where he gives legal advice to EU and private equity financed VC funds financed in respect of their investments. Besides his expertise in M&A and corporate law, Gabor has extensive experience in international investment protection law, EU state aid law and the Hungarian media law.

Banking & Finance | M&A | Property Law

HBK Partners is an independent leading Hungarian boutique law firm focusing on Banking & Finance, M&A and Capital Markets. Founders of our law firm previously worked for prestigious international law firms, Big Four consultancies and highly successful local law firms, as partners. Our professional experience and commitment enabled us to compile a young, talented and customer-friendly team who fully understands the business and legal expectations of both local and multinational clients. In our work, we strive to find solutions complying with international standards yet tailor-made to the peculiarities of the Hungarian legal and business environment. For years, several of our colleagues have featured as ranked practitioners and recommended lawyers by the leading legal ranking organisations.

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India

Vineetha M.G.

Samvād: Partners

Ashwini Vittalachar

1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

Private equity ("**PE**") transactions in 2018 amounted to approximately USD 35.1 billion across 761 deals. The majority of the transactions involve investment in unlisted companies. Despite non-banking financing companies ("**NBFCs**") facing liquidity concerns especially in the second half of the year, the financial services sector was the most attractive sector for PE investments in 2018. It was followed by the real estate and e-commerce sectors, both attracting substantial PE investments in 2018. 2018 was also a great year for exits, as the year saw significant PE exits of approximately USD 26 billion, being an almost 100% increase from 2017 and almost equal to the total number of exits in the previous three years cumulatively. In particular, Walmart's acquisition of Flipkart led to exits for multiple PE funds at a significant valuation. This year also saw a number of investments in start-ups, beating the earlier record in 2015.

India will continue to attract significant PE investments in the coming years.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Some of the changes in the taxation and foreign exchange law regime addressed the various operational difficulties faced by entrepreneurs as well as investors, and these measures in turn had a positive impact on the ecosystem. Please see our response in section 10 on the nature of reforms introduced in the recent past.

With these regulatory reforms and policy announcements, the general outlay for PE transactions in India continues to be positive. With the increased political stability, India continues to be an attractive destination for PE investments.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

Political stability and socio-legal reforms will continue to play a key role in ensuring a further raise in PE investments in India. From a sectoral standpoint, IT-ITeS, e-commerce, consumer, insurance and financial services sectors (both traditional and fintech) seem to be promising in the next 12 months. Large global PE giants such as SoftBank, Macquarie, KKR, Carlyle, CPPIB, CDPQ continue to be bullish about investment in India.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Co-investment structures have gained popularity in recent times. As co-investment structures offer access to funds, better assets, increased degree of control over investment portfolios and increased returns from capital, PE houses have increasingly adopted this medium of investment. It is also becoming increasingly common to see control stake transactions, or transactions involving PE investors holding significant stake in the portfolio company. Transactions are typically structured either as a primary investment or a secondary acquisition, or a combination of the two.

PE investors typically invest in a combination of equity shares and convertible instruments (such as convertible preference shares, warrants and convertible debentures) wherein, the investors also typically acquire a nominal number of equity shares to exercise voting rights. The convertible instruments are mandatorily convertible when issued to offshore investors.

Convertible notes are essentially instruments evidencing receipt of money initially as debt, which is either repayable at the option of the holder or which converts to equity shares of the company. Indian foreign exchange laws previously did not permit convertible notes to be treated as "investment" and were therefore not a popular instrument for investment. The foreign exchange laws have recently allowed convertible notes to be issued by registered start-ups to foreign investors for raising funds, subject to a maximum convertibility period of five years from the date of issue.

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2.2 What are the main drivers for these acquisition structures?

Regulatory considerations such as the tax regime, foreign exchange laws and anti-trust laws act as a catalyst in structuring acquisition transactions. Several restrictions are imposed on Indian companies for investments/acquisitions especially in case of share acquisitions/investments by a foreign investor. Restrictions such as who can be an eligible investor, the nature of instruments that can be issued, limits on investment and sectoral caps, government approval for investments, anti-trust approvals, timelines for payment of consideration and issuance of securities and feasibility of escrow arrangements are some of the restrictions imposed by the foreign exchange laws.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

PE investors generally hold between 10%–25% of the share capital of a company and the controlling stake is typically held by the promoters/promoter groups. In the recent past, there has been an increase in promoters/promoter groups having a minority stake in the group, with the capital structure of the company being dispersed across multiple investors. Where the PE investor is desirous of acquiring a controlling stake, promoters retain anywhere between 10%–25%. There are also upside sharing structures based on the performance of the company.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

It is common for PE investors to hold a significant minority stake in the company. Accordingly, customary protections such as board seat, veto rights, quorum rights, information/inspection rights, tag-along rights and exit rights play a key role in ensuring that an investor's rights are protected. The scope and extent of veto rights granted to minority investors are generally limited, especially to matters affecting the rights attached to such investors' shares . It is possible to see special investor consents being structured around economic rights. In the case of an event of default, it is common to see certain specific exit rights kicking in, such as accelerated drag for undertaking the strategic sale of the company

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

In a promoter-led company, management typically holds 12%–15% of the equity shares in the company along with other benefits like employee stock option plans ("**ESOPs**") and compensation packages. Adopting appropriate incentive structures to adequately incentivise the management team is an emerging trend.

A typical vesting of ESOP period ranges from four to five years, with compulsory acquisition proposed in case of termination on account of egregious situations such as fraud, embezzlement, wilful breach and other similar instances.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

A management equity holder is considered as a bad leaver where his exit is for "cause" or in case of voluntary resignation. Termination for "cause" covers termination on account of fraud, embezzlement, wilful breach, significant non-performance, being held guilty of any crime involving moral turpitude or such other instances that cause grave reputational loss to the company or its investors.

A management equity holder is typically considered as a good leaver where his exit is for reasons other than "cause".

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

The portfolio companies are typically board-managed with the senior management team reporting to the board.

PE investors seek to have a right to nominate directors on the board of the portfolio companies. Presence of such director is made mandatory for quorum, and meetings are adjourned in the absence of such quorum. Very often, the investors also require appointment of independent directors to ensure the highest level of corporate governance. Investors also seek to appoint observers to the board to attend meetings. Such observers are appointed in the capacity of non-voting and speaking observer.

The governance arrangement includes the ability of the PE investors to exercise the veto rights on certain identified matters, which could even include operational matters. Acquiring such rights in the listed companies does trigger an open offer. One would also notice transfer restrictions being imposed on the promoters and the existing managements and this also ensures that they have enough skin in the game for creating shareholder value. The PE investors have also ensured that the management team is adequately incentivised by way of implementation of employee stock option schemes.

The articles of association ("AoA") of the company are the bye-laws of the company and the governance structure is reflected in the AOA. The AOA is a publicly available document.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

PE investors are given significant veto rights with respect to all material aspects of the business of a portfolio company and its subsidiaries including in relation to corporate restructuring, fund raising, related party transactions, incurring indebtedness, disposal of assets, appointment and removal of key management team, litigation, change in business, diversification of the business etc. These rights are even provided to PE investors holding minority stake. In listed companies, SEBI is trying to make a distinction between "protectionist rights" and "operational rights".

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3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

Yes. There are certain restrictions in effectively exercising the veto rights at the board level of the portfolio companies, given that every director has a fiduciary duty towards the company, which may or may not always be aligned with the interest of the investor.

However, there are no such limitations on the effectiveness of veto arrangements at the shareholder level. As a result of this, very often the veto rights are structured at the shareholder level rather than at the board level. In certain cases, such veto rights are exercised by way of investor consent even prior to the matter being taken up at the board/shareholder level.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

PE investors holding majority stake in a company should ensure that they do not act in an unfair, fraudulent or oppressive manner against the interest of minority shareholders. A shareholder is considered a minority shareholder if he/it holds at least 10% shares in the company. The Companies Act, 2013 provides the following protections to minority shareholders:

- Right to file an application before the tribunal in the event affairs of the company are being conducted in a manner that is prejudicial to public interest or prejudicial or oppressive to the shareholder(s) or prejudicial to the interest of the company.
- Right to file an application with the tribunal (class action suit) against the company, directors, auditors in the event the affairs of the company are being conducted in a manner prejudicial to the interest of the company, its members or depositors.
- Consent rights with respect to merger and acquisitions.
- Minority shareholders of listed companies have the right to appoint a director to represent the interest of such small shareholders in the company.

It is important to note that a promoter holding a minority stake can also allege oppression and mismanagement in the event of arbitrary exercise of control rights by a PE investor.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

The shareholders' agreements often contain restrictive covenants regarding competition, solicitation and confidentiality to ensure promoters maintain executive roles in the company. Enforceability of non-competition restrictions is limited to sale of goodwill under the Indian laws, but the enforceability of breach of confidentiality and non-solicitation restrictions are possible. Furthermore, non-compete restrictions are not enforceable post-termination of employment, but Indian courts take into consideration reasonability of such restrictions while determining the scope and extent of its enforceability.

Apart from the above, there are no restrictions on the contents and enforceability of the shareholders' agreement. The AoA of the company incorporate the shareholders' agreement to extend dual protection *vis-à-vis* enforcement, in case of breach. At the time of the IPO, SEBI and stock exchange typically requires the termination of the shareholders agreement.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

The directors have a fiduciary duty towards the portfolio company under Indian laws. The Act makes directors of a company responsible for everyday affairs and management of the company. The Companies Act, 2013 has codified the liabilities of the directors in detail. Penalties prescribed for as a consequence for the breach of such duty in contravention of the Act ranges from 50,000 Indian rupees to 250 million Indian rupees. Certain offences in the Act are even punished with imprisonment, apart from monetary penalties. While a nominee director will hold a non-executive position on the board, he nonetheless is required to discharge and fulfil his fiduciary obligations.

Nominee directors are deemed to have knowledge of the proceedings of the board and they cannot recuse their liability on account of lack of knowledge of the contravention and express consent over such contravening act. Nominee directors are as liable as executive directors are in their fiduciary capacity to work in the best interest of the company, and not the nominators. Consequently, the PE investors are choosing to appoint a non-voting "observer" on the board, instead of appointing a director to ensure compliance with corporate governance.

From a process perspective, PE investors need to comply with the Act while appointing nominee directors. Directors are required to obtain director identification numbers before being appointed on the board of the portfolio companies. They are required to disclose interest at the time of appointment and any subsequent changes in their interest while holding that position in a company. The Act provides a list of disqualifications for the appointment of directors, which includes failure to procure a director identification number, a person being an undischarged insolvent, a person being convicted by a court for any offence involving moral turpitude or others, to name a few. In addition, the directors are not permitted to participate in meetings where a contract or arrangement in which such directors are interested in being discussed.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Directors of a company are bound to act in the best interest of the company, as they have fiduciary duty to do so under the Act. There could be a possible conflict of interest if a PE investor nominates a common nominee director on the board of two of its portfolio companies that are competing with each other or engaged in business transactions that are not on an arm's-length basis and in the ordinary course of business. In such scenarios, the nominee director typically steps down from the board of one of the companies to avoid conflict of interest.

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It is fairly remote that interest of the company will be separate from that of the PE investor since the PE investor's investment is dependent on the growth and success of the company.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

The timeline for completion of PE transactions in India depends on a number of factors, including the sector of investment, antitrust issues, the nature of the transaction, size of the target's business, deal size, structuring and tax (both domestic and international) considerations. PE investments into a regulated sector or an investment in excess of the prescribed sectoral cap or an investment likely to affect the competitive market practices would require approval from the concerned regulatory authority or ministry/department through the Foreign Investment Facilitation Portal ("**FIFP**"). Accordingly, timelines of transaction would be affected if approval is required especially from the Reserve Bank of India ("**RBI**"), Security Exchange Board of India ("**SEBI**") in case of a PE investment into a listed entity, Competition Commission of India ("**CCI**") – the Indian antitrust regulator, the Insurance Regulatory Authority of India ("**IRDAI**") or other similar regulators. Consent from the CCI is becoming very critical in PE deals, especially given the nature and size of the deals. While the competition regulations do provide for certain exemptions from notifying the CCI, the CCI's decisions in the past have tended towards narrowing down the scope of these exemptions.

4.2 Have there been any discernible trends in transaction terms over recent years?

PE investments are structured by way of a subscription to equity, convertible preference shares or convertible debentures.

In terms of transaction terms, there has been significant changes in promoter protections typically extended. Caps on promoter liability, absence of joint and several liability with the company (especially where promoters hold a minority shareholding), promoters being given an exit in certain special circumstances such as change in control, sale to a competitor and promoters exercising veto over key decisions alongside the PE investors, are examples of such promoter rights being negotiated. This is a departure in the transaction dynamics as typically these rights were previously only extended to a PE investor and not to a promoter. Upside sharing structures are also becoming more common.

Tax indemnities continue to be negotiated in detail in the context of exit by a PE fund due to an increased tax burden under Indian laws (even where the buyer and seller entities are offshore companies but dealing with Indian securities). In case of sale by one offshore PE fund to another offshore entity, tax exposures and tax indemnities are being looked at more closely with a view to provide necessary comfort to the buyer entity. At the same time, such comfort is not drawn at the cost of an increased indemnity exposure for the selling of a PE entity. Consequently, tax indemnity insurances have gained popularity to help mitigate this risk.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

In India, PE investors are rarely party to public-to-private transactions. In addition, Indian exchange control regulators prohibit foreign investors from seeking guaranteed returns on equity instruments in exits.

A minimum of 25% of the share capital of a listed company is required to be publicly held (i.e., to be held by persons other than promoters/promoter groups). Depending on the rights available to the PE fund, the PE fund may be classified as a part of the public shareholding.

The SEBI (Delisting of Equity Shares) Regulations, 2009 ("**Delisting Regulations**") governs the delisting of equity shares of listed companies. Under the Delisting Regulations, no company can make an application for delisting and no recognised stock exchange shall permit delisting of shares of a company in the following circumstances:

- pursuant to a buy-back of equity shares of the company;
- pursuant to preferential allotment made by the company;
- unless a period of three years has lapsed since the listing of that class of equity shares on any recognised stock exchange; or
- if any instruments issued by the company, which are convertible into the same class of equity shares that are sought to be delisted, are outstanding.

Several other restrictions apply to a listed company proposing to delist, including minimal shareholding that a promoter needs to hold pursuant to the delisting and price determination for the delisting. Delisting is therefore not a preferred mode of exit for PE investors, who typically consider an initial public offer as a mode of exit from the portfolio companies and prefer the liquidity by way of listed shares. Consequently, PE investors invest at a time when the portfolio companies still have three to five years before listing and exit the company at the time of listing or shortly thereafter. Alternatively, PE investors invest in companies after listing. PE investors are, at times, limiting their equity exposure in Indian companies by investing through a combination of equity or preferred capital and listed non-convertible debentures ("**NCDs**"). Investments through listed and unlisted NCDs are less regulated and may be secured by Indian assets in favour of an Indian resident trustee. PE investors are able to structure their investments in a manner that maximises capital protection by stipulating a minimum return on the NCDs, while also participating in the risks and rewards of the portfolio company as a shareholder.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

In order to protect its investment, PE investors usually negotiate a shareholder's agreement and a registration rights agreement with the portfolio public company, in which the PE fund and management are invested. It is also possible for the transaction to be structured in a way that the portfolio company becomes the holding company or subsidiary of the listed entity, so as to give greater flexibility to the

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parties on the nature of rights that may be negotiated. A PE investor also typically seeks detailed representations and warranties on the business of the portfolio company as well as indemnity protections, and these serve to cap the fund's exposure.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

Cash consideration is the most preferred consideration structure. In certain transactions, the consideration is structured by way of swap or "in specie" distribution. On the sell-side, PE investors desire to complete the investment in one tranche. While on the buy-side, PE investors prefer a tranche-based consideration structure, although they are open to a single tranche consideration structure as well. Tranche-based consideration could also incorporate financial thresholds/milestones which may be tied to future operations of the company.

In case of tranche-based acquisitions, it is common to have the majority stake being acquired in the first tranche. In case of 100% acquisitions, it is common to devise a mechanism for retaining the management team. This could either be through deferred consideration payments which are linked to the performance of the target company or through promoter earn-outs/ratchets. However, in case of transactions coming under the ambit of foreign exchange laws of India (applicable where one of the parties to the transaction is not a resident), deferred consideration structures are also permitted subject to a maximum of 25% of the total consideration being paid by the buyer on a deferred basis and such payments being made no later than 18 months from the date of the share purchase. Also, it is possible to have escrow arrangements in place in connection with such deferred payments in such transaction involving offshore parties, subject to the above terms of 25% value cap and 18 months' time cap being adhered to.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

Typically, a PE seller provides basic title and authority warranties to the buyer. Such title warranties include warranties on taxation position and anti-corrupt practices, in case of offshore parties. It is unusual for a PE seller to provide operational warranties in relation to the business of the portfolio company.

Consequently, the nature of indemnities offered by a PE seller is also limited to issues arising out of title and authority warranties. In the recent past, PE sellers, however, have shared indemnity liabilities arising out of operational warranties given by management shareholders, especially where the management shareholders are in minority.

There are a number of limitations to indemnity that are normally offered. Generally, these limitations are non-liability for indirect and consequential losses, limitations on survival period, caps on the amounts, *de minimis* thresholds and basket thresholds. These limitations, however, do not apply in case of fraud, wilful misconduct, gross negligence, or breach of fundamental warranties.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

PE sellers provide general covenants/undertakings for the completion of sale of the securities adhering to the applicable law and fixed timelines. It is common to see restrictive covenants being imposed on the promoters and the management team regarding non-compete, non-solicitation and confidentiality. This is with a view to enable better integration post-acquisition.

Buyers usually insist on the management team entering into necessary agreements to set out the terms of their engagement with the company. The scope and extent of indemnities provided by the PE seller are explained in question 6.2.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Representation and warranty insurance (**R&WI**) has become prevalent in India in the recent years. These are typically obtained by a PE investor to cover indemnity risks. The coverage limits of such R&WI is 10%–15% of the value of the transaction and the premium typically ranges from 3%–5% of the coverage limit of the R&WI for the transaction.

Considering that the R&WI is to minimise the risks, there are certain upfront exclusions provided for by the insurer. These exclusions include losses arising on account of anti-bribery and corruption, fraud by sellers and other transaction-specific exclusions.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

The scope of warranties provided by the seller are typically limited by the disclosure provided under the disclosure schedule. Additionally, liability for indemnities are subject to certain limitations as discussed in question 6.2.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

PE sellers seldom provide any security for warranties/liabilities. However, for specific indemnity matters, the parties usually agree to an escrow/retention mechanism under which a certain percentage of the total consideration is held in an escrow account for a certain time period and thereafter released, subject to absence of any indemnity claims.

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6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Buyers in a PE transaction provide for representations and warranties regarding their ability to fund the investment. In some cases, commitment letters, corporate guarantees or details of financial arrangements as a representation are also given by the buyer. Typically, the share purchase agreement would include a break fee as well as specific performance rights in case the buyer fails to comply with its obligations.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are not very prominent in Indian PE transactions. However, if a reverse break fee is provisioned for, it is generally limited to a certain percentage of the purchase price and the amount may be held in escrow till the expiry of the closing date.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

Exit by way of an IPO is rarely used by the PE investors though it is the preferred exit option for the investors.

The procedure involved in an IPO is governed by the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("**ICDR Regulations**") and the IPO process is typically run by the company and its promoters in consultation with the PE investors. Once the shares of the portfolio company are listed then the entire pre-issue capital of the portfolio company is locked in for a period of one year. There are very limited exceptions to this rule. Further, one of the most important aspects to ensure in the IPO process is to ensure that the PE investor is not designated or identified as a "promoter". There are several obligations imposed on promoters at the time of listing (including disclosure obligations at the promoter group level) and post listing. Where the PE investors hold majority stake in the portfolio company, this issue becomes more critical. In the past, some of the investors have obtained specific exemption from being classified as a promoter. This is one aspect, which needs to be discussed with the merchant bankers upfront. Also, at the time of IPO, SEBI and the stock exchanges require that the shareholders agreement be terminated.

If the PE investor is also looking to exit by way of a secondary offer for sale, the investor will also need to review and negotiate all the IPO-related documents since it will need to sign off on these documents including provided indemnities. Further, the nominee director of the PE investor will also be required to execute the IPO-related documents including the prospectus.

A failed IPO can have an adverse impact on the valuation of the PEs. Therefore, IPO exits are only attempted where the company is confident of completing it successfully.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

PE investors with substantial stakes or considerable operational control may be named as "promoters" in the offer document. A "promoter" for the purposes of an IPO is subject to several responsibilities and obligations, including a three-year lock-in on 20% of its shareholding. Further, the entire pre-issue share capital is locked in for a period of one year.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Since PE investors tend to negotiate several exit channels, a dual-track exit process is very common. This allows PE investors to prepare themselves for an IPO even as they negotiate terms for a third-party sale. Private sales and IPOs are the preferred modes of exit for PE investors in India.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Banks are not permitted to extend loans for funding an acquisition of shares in India except in relation to acquisitions in the infrastructure space subject to certain restrictions.. Therefore, PE investors rarely raise debt finance from banks for their investments in India. However, some investors do approach non-banking finance companies for financing acquisitions.

Foreign sources such as external commercial borrowings ("**ECBs**") including, privately placed NCDs (which are comparatively less regulated) are emerging as sources for funding.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

Other than the restrictions in loan extension by banks for financing acquisitions, the recent changes to the External Commercial Borrowing Master Direction of RBI (which regulates the international borrowing and lending transactions) has brought in both liberal and restrictive changes. The security package in relation to such funding will need to be appropriately structured given the restrictions under the Companies Act, 2013, especially in the case of public companies.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

Debt financing has been gaining maturity in the Indian market. Promoters looking to retain independence are looking to debt

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financing through mezzanine debt structures. In particular, venture debt and convertible notes have gained significant popularity amongst early growth stage companies.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

There are specific taxation provisions governing Indian companies and PE investors that require primary investments to be priced appropriately. From a target's perspective, if shares are issued to resident investors at a price higher than the fair market value, as determined on the basis of specific formulae prescribed by tax laws, the target will be charged (subject to certain exceptions) to tax on the excess so received as income in its hands. Lately, Indian tax authorities have been examining share premium charged by Indian companies on the allotment of shares to non-residents also, and are attempting to tax Indian companies on excessive share premiums.

A non-resident investor will be taxed in India, subject to relief as available under the relevant tax treaty between India and the country of residence of the investor. Under the Income Tax Act, 1961 ("**IT Act**"), income earned by a domestic fund registered with SEBI as a venture capital fund ("**VCF**") and certain categories of alternate investment fund ("**AIF**"), are not subject to tax as per Section 10 (23FB) and Section 10 (23FBA) of the IT Act. Such VCFs and AIFs have been granted pass-through status under Section 115U of the IT Act with respect to income other than business income. Business income of such AIF is taxable at the fund level, at applicable rates, and is exempt in the hands of the unit holder. However, no tax pass-through status is applicable to Category III AIFs. Further, Section 56(2) of the IT Act, exempts a VCF paying a share premium for subscription of shares of portfolio company from being taxed under the head "income from other sources".

While there are no specific tax exemptions available to FVCIs, as per Section 90(2) of the IT Act, the provisions of the IT Act apply to a non-resident investor investing from a country with which India has a tax treaty, only to the extent the provisions of the IT Act are more beneficial. Thus, an FVCI investing through a tax treaty jurisdiction can avail benefits under the relevant tax treaty. It is pertinent to note that India has amended its double tax avoidance treaties with Mauritius and Singapore taking away such tax benefits on and after April 1, 2017. However, investments through entities in Mauritius or Singapore, made before April 1, 2017, have been grandfathered. The GoI also introduced the Generally Anti-Avoidance Rule ("**GAAR**") with effect from April 1, 2017 with the aim of providing transparency in tax matters and to curb tax evasion. Where a transaction is structured, devoid of any business reason with the principal aim of obtaining a tax benefit, such a transaction is deemed impermissible for the purposes of such tax benefit. Consequently, GAAR does not apply if the jurisdiction of a foreign investor (including a FVCI) is finalised based on commercial considerations and the sole purpose of the arrangement is not to obtain tax benefit.

It is also important to note that a foreign company is to be treated as tax resident in India if its place of effective management ("**PoEM**") is in India. PoEM is "a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are in substance made". If the foreign company becomes resident in India, it would be taxed at an effective rate of 41.2%–43.26% on its global income in India. Accordingly, PE investors must exercise caution while structuring their fund management structures, and in some cases their investments, in Indian companies.

Offshore structures are still common, with respect to investments in to Indian portfolio companies.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

It is common to have both incentive shares as well as deferred/vesting arrangements, especially in the context of employee stock options, while structuring PE transactions. ESOP schemes cannot be made available to promoters, hence in such cases alternative incentive structures will need to be implemented.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

Capital gains tax is one of the most significant considerations while exploring sale/roll over of investments into newer acquisition structures. Where an asset is held for less than 36 months (12 months in case of listed securities) before transfer, such transfer is eligible to short-term capital gains ("**STCG**") tax, whereas gains arising from the transfer of assets after 36 months are treated as long-term capital gains ("**LTCG**") and taxed accordingly. LTCG on sale of debt instruments will be taxed at the rate of 20% (both listed and unlisted instruments). Further, LTCG on the sale of equity instruments will be taxed at the rate of 10% (both listed and unlisted instruments). STCG on the sale of equity-linked mutual fund and securities is taxed at the rate of 15% (both listed and unlisted instruments).

However, the aforesaid may not apply in case the seller is an offshore entity in a jurisdiction having a double taxation avoidance treaty with India and entitled to benefits thereunder.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

The Government of India enforced the GST regime in 2017, unifying all indirect taxes under a single tax regime. The new regime provides for a single registration and will facilitate the setting-up of new businesses and the growth and expansion of existing businesses.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

The RBI in November 2017 issued the Foreign Exchange

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Management (Transfer and Issue of Security by a Person Resident Outside India) Regulations, 2017 (FEMA 20) to replace, *inter alia*, the Foreign Exchange Management (Transfer and Issue of Security by a Person Resident Outside India) Regulations, 2000 (Old FEMA 20). The FEMA 20 introduced, for the very first time, the definition of "foreign investment" and categorised it into "foreign direct investment" and "foreign portfolio investment". This categorisation fundamentally changes the foreign exchange regime of India by making it an "investment-specific" regime, as compared to an "investor-specific" regime under the Old FEMA 20. By virtue of these amendments, a new route has also been made available for foreign investment by persons resident outside India in a listed Indian company up to a limit of 10%. The foreign exchange laws have also relaxed the framework for ECBs thus making ECBs an attractive route of investment.

On the regulatory front, the government and regulators have made several transformative policy changes that are helping to reshape the manner in which investments into India are structured. Some of these include:

- Resolution of the Mauritius tax conundrum: The amendment to the India-Mauritius Double Tax Avoidance Agreement ("**DTAA**") to provide a calibrated phase-out of the capital gain tax exemption, while grandfathering tax benefits to investments made until March 2017, provides certainty on an issue that has persisted for over two decades. The India-Singapore DTAA was also re-negotiated on similar lines.
- Introduction of a 10% tax rate on LTCG arising from transfer of equity shares of listed companies which reversed a tax policy that exempted such gains since 2004.

  Introduction of the GAAR and the concept of PoEM for determining the tax residence of foreign companies in India.
- Allowing foreign investment in the SEBI-regulated AIF under the automatic route with a liberal policy that allows AIFs, whose sponsor/fund manager are owned and controlled by resident Indian citizens, to make investments in India without attracting exchange control limitations.
- Gradual amendment in the domestic tax law to implement the actions agreed under the Base Erosion and Profit Shifting ("**BEPS**") project to curb tax evasion. India, as part of the BEPS project, has agreed to amend its tax treaties by signing the multilateral instrument ("**MLI**") along with 78 other jurisdictions.

The PE/venture capital industry in India is clearly in transition. The rules for investment into India have been changed to provide foreign investors a sense of certainty and clarity and at the same time ensure that India collects its fair share of tax on the income earned from investments in India. Going forward, this approach may provide a significant impetus to PE/venture capital activity and capital flow to India, which is sorely needed for growth of the Indian economy at large.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

Certain transactions may require regulatory scrutiny, owing to the sector of operations, size of the investment and such other similar considerations. Details of the same have been set forth in question 4.2. Apart from these there are no other peculiar regulatory scrutiny, especially on grounds of national security.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

The scope and extent of legal due diligence depends on the term of the operations of the company. Previously, due diligence was limited to examining traditional aspects of legal, tax and financial compliances. Particularly, legal due diligence was limited to examining issues of compliance such as review of the corporate records, approvals and licences, contracts of the company and compliance under various laws applicable to the business of the company. The process, however, has now extended to examining forensics, commercial, HR and IT issues. The investee or target company's competitive positioning, promoter integrity, management gaps and potential exit routes are also evaluated. Legal due diligence is most often conducted by external counsels and is completed within three to five weeks, depending on the scope of the diligence.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Anti-corruption laws and compliances thereunder, play an important role in PE transactions. The Prevention of Corruption Act, 1988, criminalises the receipt of illegal gratification by public servants in India. However, the legislation currently does not cover private sector bribery in India. An amendment to the act criminalising private sector bribery is pending approval by the Indian Parliament. Hence, given the gap in the scope of applicability of anti-corruption laws in India *vis-à-vis* private bribery in offshore jurisdictions, offshore PE investors specifically seek compliance with the more stringent/encompassing anti-bribery laws as applicable in their jurisdiction, by way of contractual undertakings.

PE investors seek warranties and covenants from the management team confirming compliance with anti-bribery laws including the Foreign Corrupt Practices Act, 1977 ("**FCPA**") and the UK Bribery Act, 2010 ("**UKBA**"). Breach of such warranties/covenants entitles the PE investor to seek an immediate exit, in addition to indemnity/damages as applicable.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

As a shareholder, a PE investor has negligible liability for any breach by a company. However, the nominee director may be subject to liabilities, especially in case of breach of his duties. There are very limited circumstances where the corporate veil of the company is pierced by Indian courts.

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11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Adversarial dispute resolution through the courts in India pose challenges in terms of the time and costs involved. Therefore, we recommend incorporation of institutional dispute resolution mechanisms such as arbitration in agreements which are proposed to be executed by PE funds with portfolio companies. While a robust legal framework for conduct of arbitrations is evolving, at present, overseas institutional arbitrations such as the Singapore International Arbitration Centre, is preferred for resolving disputes effectively and in a commercially savvy manner.

The threat of initiation of actions under the FCPA and the UKBA are an area of increasing concern for PE funds. The aforesaid laws expose PE funds to liabilities in the event their associates or employees in foreign countries engage in corrupt practices. Such laws make it critical for PE funds to conduct adequate anti-corruption due diligence in connection with their investments and conform to adequate safeguards against corruption throughout. Failure to do so exposes the funds to potential successor liabilities, which can result in huge fines and penalties, often for months or years after a deal is closed.

Tax and regulatory bottlenecks do pose a few challenges to PE investors, especially those offshore. To this extent, the government has taken note of these concerns and is implementing steps from time to time, to mitigate such concerns.

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Vineetha has extensive experience in advising clients on PE investments and venture capital. Vineetha represents and advises various PE investors including *Government of Singapore Investment Corporation, New Silk Route*, *Morgan Stanley Infrastructure Fund*, *Cerestra Advisors, Sequoia Capital*, *ICICI Ventures and IDFC Investments* in relation to their investments in India, in both listed and unlisted companies, as well as on exits from such investments. Vineetha has also represented and advised *Warburg Pincus, IDFC Private Equity* and *SBI Macquarie* in relation to their investments and exits in India.

Vineetha has been awarded "*Most Influential Woman in Private Equity Investments 2018 – India*" by *Acquisition International – The Voice of Corporate Finance*.

Vineetha has been recognised by *Insight Success* magazine as one of "*The Top 10 Powerful Lawyers in 2018*".

Vineetha is ranked Band 2 in Banking & Finance and Band 3 among PE lawyers in India by *Chambers & Partners* 2019, 2018 and 2017 and sources consider her "*one of the most active private equity professionals in the market*", adding that "*she is a very knowledgeable and constructive presence at the table*".

Vineetha "*is frequently engaged by private equity investors and has extensive experience of fund-raising work*" (*Chambers & Partners Asia-Pacific* 2016).

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Ashwini has more than a decade's experience in advising on PE and venture capital transactions and has been instrumental in the establishment of the New Delhi office of the firm. She is an established name in the PE and venture capital industry and has acted for a broad spectrum of clients that include PE investors, mid-to-late stage companies receiving PE investments, existing venture capital investors, as well as promoters and start-ups. Her clients in this area include Delhivery, PolicyBazaar, PaisaBazaar, Zomato, Fundamentum, Times Internet, EightRoad Ventures, Aujas and Zap. She has represented different stakeholders across the entire lifecycle of a transaction – right from an early stage investment, to co-investment, mid-to late stage investments, negotiation of non-participating investor rights, as well as investor exits, giving her a holistic and practical approach at the negotiation table to balance rights of diverse stakeholders.

Ashwini works extensively on PE, venture capital, cross-border M&A and joint ventures, as well as acqui-hires, business restructures and other acquisitions. Her expertise extends to strategic investments/acquisitions as well as those involving financial investor exits and promoter buyouts. Ashwini is also an established practitioner in employment law and draws on this expertise in structuring transactions.

In addition to co-authoring, with Vineetha M.G., this present chapter for *The International Comparative Legal Guide*, Ashwini co-authored a chapter on "Employment laws in India" in *Getting the Deal Through*, among several other publications.

She is recommended by All China Lawyers Association as one of the leading lawyers in Belt and Road region.

Ashwini is admitted to practise law in India. Ashwini Vittalachar is recommended practitioner for Labour & Employment (*The Legal 500* 2019, 2018, 2017 and 2016).

Ashwini Vittalachar has played a key supporting role in many of the firm's recent M&A deals. This has included acting on cross-border M&A deals in the life sciences and automotive sectors. (*Chambers & Partners* 2015).

Ashwini is singled out by clients for her "*communication skills, quick understanding of key business issues, and negotiating ability*". She has acted on several mandates for clients in the automotive and pharmaceutical sectors of late (*Chambers & Partners* 2014).

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The majority of our Partners have a rich mix of domestic and international experience – having worked in several international financial centres outside India, including Hong Kong, London, New York and Singapore. We strive to provide our clients with innovative and simple solutions to their complex legal and business challenges in India.

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Indonesia

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

The most common types of private equity transactions in Indonesia are private equity transactions through direct equity participation, mezzanine loans, and convertible notes or bonds where the loan can be converted into shares in the call of the private equity investor upon certain events (e.g. IPO, change of laws, etc.). For certain tax purposes, the loan plus warrant would replace the convertible notes/bonds structure.

The current state of the market for private equity transactions in Indonesia is stable at the moment and there has been no significant change in the types of private equity transactions being implemented in the last two to three years. However, we note that there are more private equity investors who invest directly through equity instead of loans right now due to the change in regulation which now allows some types of business activities, which were previously closed for foreign investment, to be owned directly by a foreign investor.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Despite experiencing slowing growth, Indonesia's economy keeps growing. Indonesia also has a large domestic consumption base and natural resources. These factors make investment in Indonesia interesting.

Even though Indonesia is an interesting market for private equity investments, some of the investors still doubt investing their money in Indonesia due to its complicated bureaucracy, lack of infrastructure, high corruption rate and the uncertainty of the laws and regulations.

Nevertheless, Indonesia's investment climate remains conducive and attractive for private equity investors. The government also realises the potential of private equity investment for economic growth. In this regard, the government has tried to simplify the investment process to make it easier for investors to invest in Indonesia.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

The private equity investor will keep focusing their investment on: (i) the unicorn of tech digital companies, as this tech/digital business trend is booming lately; (ii) logistics; and (iii) financial technology for the payment and crowd funding. For the longer-term transaction, they will probably focus on co-working space, healthcare, and financial institutions as these have been proven as the traditional investment of private equity investors.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

As previously stated, private equity investors would prefer to invest in equity directly to the target unless the negative lists or certain regulations prevent them from doing so. They normally would have a holding company in a jurisdiction with a good tax treaty with Indonesia. They also would provide mezzanine loans to the target to not only boost the financial support to the target, but also to the mechanism to control the target as lender.

There is a new structure/trend that is developing for targets that are start-up tech digital companies. In this case, the investors usually require the founders of the start-up company to establish a foreign holding company (in a country that they consider friendly for their investment, usually in Singapore). The investors will invest directly in the newly set up foreign holding company and then this entity will acquire 100% of the shares of the Indonesian target company.

2.2 What are the main drivers for these acquisition structures?

The main drivers for these acquisition structures are: (a) the exit possibility; (b) the negative list issued by the authorities where some business activities are closed or restricted for foreign investment; and (c) the dividend repatriation and tax consideration.

Factors (a) and (c) are the two factors that drive the new trend of setting up a foreign entity for investment purposes (as mentioned in question 2.1 above). The investors request the founders of the target company to establish a new entity in a country which they consider

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to be investment-friendly for them (in regard to the tax treatment and exit possibility) so that they can achieve their main goal – i.e. exit from the investment with optimum upside.

For factor (b), if the line of business is closed or restricted for foreign investment, then the private equity investor cannot easily invest through equity in the Indonesian target company. Therefore, they will use convertible bonds where they will require the same rights as if they are shareholders in the target company, or use other sophisticated structures such as back door listing, utilisation of venture capital or mutual funds as a holding company, etc.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

The equity structure of the target company may be in the form of: (i) common/ordinary shares; and/or (ii) other classes of shares having different rights (voting right, dividend right, liquidation right or right to nominate directors/commissioners) and/or a different nominal value compared to the common shares. Law No. 40 of 2007 regarding Limited Liability Companies (**Company Law**) permits the issuance of these different categories of shares and it is quite common in private equity transactions.

It is also possible and quite common for an Indonesian company to have a management or employee stock option plan. For this type of stock option plan, there are two common ways being used by the company, i.e. (a) the stock option plan has been issued and held by the founders to be later given to the eligible employee/management, or (b) the stock option plan will only be regulated in the shareholders' agreement and will be issued later on once the rights have arisen.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

The equity structure of the target company is usually in the form of: (i) common/ordinary shares; and/or (ii) other classes of shares having different rights (voting right, dividend right, liquidation right or right to nominate directors/commissioners) and/or a different nominal value compared to the common shares. The Company Law permits the issuance of these different categories of shares and it is quite common in private equity transactions. In the case of minority position, there would not be many different structuring considerations from the abovementioned other than having stricter reserved matter, options to increase ownership percentage and a certain put option for the exit.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Members of key management or key employees of the target company are typically included in the management incentive plan. The typical range of equity allocated to the management is different amongst one company to the other, but usually in the range of 5–10%. The vesting period for this management stock option plan varies from one private equity investor to the other. A two to three-year vesting period is often seen (subject to any lock-up provisions under the relevant laws and regulations).

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

The management equity holder is usually treated as a good leaver due to: (i) death; (ii) incapacity; or (iii) retirement. As the opposite, they are treated as a bad leaver due to: (i) resignation from the company prior to certain agreed period of time; or (ii) dismissal for gross misconduct.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

The following features are frequently included in the governance agreement of private equity investments in Indonesia:

- Investor's representation on the Board of Directors **(BOD)** and Board of Commissioners (**BOC**).
- Certain protective rights to the investor (reserved matter) which require that certain actions cannot be taken without the affirmative approval of the investor.
- Right of first refusal and tag-along right.
- Certain information and audit rights.
- Exclusivity to key personnel.
- Non-compete and non-solicitation provisions (if applicable to the business of the target company).
- Deadlock mechanism.

The Company Law does not require that the abovementioned governance agreement must be made publicly available in the articles of association of the company. They can stay in the shareholders' agreement between the parties. However, usually the private equity investors will pursue that right to be included in the articles of association of the target company so that it will be publicly available to the other third parties.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

As discussed in question 3.1 above, the private equity investors and the other shareholders of the target company may agree on a list of reserved matters, outlining the key decisions which require the investors' approval, either at the shareholder level or at the board level (through the directors and/or commissioners nominated by them). This effective veto ensures that no key decisions are entered into without the consent or approval of the investors.

For a private equity investor who takes a position as a minority shareholder, they usually require the following reserved matters to protect their rights: (a) issuance of new shares or convertible instruments coupled with anti-dilution rights; (b) transfer of shares of the other shareholders combined with tag-along; (c) change of articles of association and management team; (d) entry into affiliated parties or material transaction; (e) dividend distribution and buyback shares; (f) proposed merger, acquisition, liquidation and litigation of the target company; (g) approval of the business plan; and (h) put option.

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3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

There should be no limitations on the effectiveness of the veto arrangements at either the shareholder level or the director nominee level. The only problem is if this arrangement is not stated in the articles of association of the target company. In that case, if the BOD of the company take some reserved matter actions without the approval of the private equity investors, the action still binds the company and protects the third party in good faith.

In order to minimise that kind of problem, the private equity investors should make sure that the veto arrangements are perfectly written in the articles of association of the company so that the third party understands the veto arrangement as well.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

Indonesian law does not recognise the concept of fiduciary duty of majority shareholders to the minority shareholders as recognised in the U.S. system. However, for special transactions such as merger and acquisition transactions, the Company Law requires the company to pay attention to the right of the minority shareholders and to buy back the minority shares to a certain extent.

In addition, the Company Law also regulates the rights that the minority shareholders with a minimum of 10% of the shares in the company have rights to: (i) commence a court proceeding against the BOD and BOC of the company; (ii) request the court to commence an investigation against the company; and (iii) seek the dissolution of the company.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Although shareholders' agreements often contain a provision stating that its terms would prevail over the articles of association of the company if there is any discrepancy between them, Indonesian courts would generally give credence to the articles rather than the terms of the shareholders' agreement, since the articles of association is a public document whereas the shareholders' agreement is merely a contractual obligation amongst the parties to the agreement. As such, in the case of a dispute (and there is discrepancy), the investor's rights under the shareholders' agreement would be enforced under contract law.

There is no clear restriction that the shareholders' agreement cannot be governed under foreign law. However, considering that the object of the shareholders' agreement is the target company which is located in Indonesia, it is better to govern the shareholders' agreement under Indonesian law. In addition, kindly be advised that foreign court judgments cannot be enforced directly in Indonesia. Therefore, it will be difficult if the governing law of the shareholders' agreement is foreign law.

For this reason as well, the preferred dispute resolution mechanism in a contract involving a foreign investor is to utilise arbitration in an internationally recognised arbitration venue. In the event that a foreign investor successfully obtains an arbitral award off-shore, the enforcement against the Indonesian party requires registration and enforcement of the award through the Indonesian courts.

Indonesian law does not have a clear limitation and restriction on the content of the non-competition and non-solicitation provisions in a shareholders' agreement.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

In general, the member of the BOC and BOD must comply with the requirements set out under the Company Law, i.e. they have:

- never been declared bankrupt;
- never been appointed as a member of a BOD or BOC of a company and declared guilty for causing the company to be declared bankrupt; and
- never been convicted for any criminal actions that damaged the finance of the state and/or the relevant financial sector.

In particular, Indonesian law clearly stipulates that a director of human resources must be an Indonesian citizen.

Members of the BOD or the BOC may be held to account personally for "losses" suffered by the company pursuant to the Company Law. However, no liabilities would attach in this context if the members of the BOD can prove that: (i) the losses did not arise due to their negligence or fault; (ii) they have performed their duties in good faith and prudence for the benefit of the company; (iii) no conflict of interest existed; and (iv) they have taken actions to prevent such losses. For members of the BOC, no liabilities would attach in this context if the members of the BOC can prove that: (i) they have conducted the supervision duty in good faith and with prudence for the benefit of the company and in accordance with the objectives and purposes of the company; (ii) they do not have a personal interest in the action of the BOD that is causing the losses; and (iii) they have given advice to the BOD to prevent the losses or the continuance of the losses.

The Company Law does not regulate the responsibility of the nominator of the BOD or BOC held accountable for actions in the company.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

In the case of an actual conflict, the Company Law is unequivocal that such director may not act on behalf of the company. In the case of a potential conflict, such director should exercise their business judgment to assess if he/she should participate in a decision that would likely lead to an actual conflict. Otherwise, they may be held accountable if something goes wrong and causes losses to the company due to their actions (as explained in question 3.6 above).

In practice, it may be difficult as a nominated director must balance their actions for the best interest of his/her nominator and for the best interest of the company (which has more than one shareholder).

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4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

As regulated by the Company Law, there are a number of notifications that need to be made to creditors, employees and other public disclosures in the event of a takeover or merger.

These notices include: a) the company's creditors would need to be notified at least 30 days before the notice of the general meeting of shareholders (**GMS**). Any objections the creditors have must be submitted at least seven days before the notice of the GMS. The merger may not proceed until all objections have been resolved; and b) the employees of the companies must be notified at least 14 days before the notice of the GMS. Investment in certain industries (for example, telecommunications and transportation) may require additional licensing and notification requirements to the relevant governmental agencies. Finally, reporting to the Indonesian Commission for the Supervisory of Business Competition (**KPPU**) may be required in certain takeover situations which fulfils the criteria for reporting requirements.

In the case that the target is a public company, Indonesia's capital market regulator, the Financial Service Authority (**OJK**) may request additional information and the investor who would be the new controlling shareholder would be required to do a tender offer post-closing transaction.

4.2 Have there been any discernible trends in transaction terms over recent years?

The round down trend quite often happens in transactions involving tech companies. The red-hot industries of the target of private equity include FinTech (the most popular FinTech industry at the moment is that of peer-to-peer lending), unicorn tech companies, healthcare, financial services, mining and retail.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

In order to be able to "go private" the target company must obtain an approval from the independent shareholders and be ready to purchase all shares from dissenting shareholders, in addition to extensive disclosure requirements and tender offer of the remaining shares. In this regard, the company must comply with the minimum capital requirement set out by the Company Law.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

The Indonesian government provides quite strict regulation for a company to be able to conduct an IPO, e.g. the long process of the registration statement, thorough verification by the authority, minimum floating, lock-up for founder shares and shares resulting from the debt equity conversion.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

Consideration structures which are typically preferred by private equity investors (on the sell-side) would be an IPO and trade sales of shares in a holding company residing in a tax haven country.

While on the buy-side, direct investment to the equity in the target company via its own vehicle in a low-tax jurisdiction, is typically preferred.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

The warranties/indemnities offered usually relate to the ownership of the shares and no threats or pending obligations that they owe in relation to such ownership.

In addition, the private equity seller would normally ask for a limitation of liability for the seller. For factual matters relating to the company, the management of the company would be able to give these only for the period where they are in office with standard clauses such as the due incorporation, constitutional documents and no threats or pending obligations.

The other warranties would normally be subject to the best of their knowledge.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

The other covenants, undertakings and indemnities usually relate to the ownership of the shares or the conditions precedent or subsequent relating to the transaction documents. The management team would covenant limited matters relating to the lack of compliance of the target company.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

This is not common in Indonesia, although several insurance carriers do provide this service nowadays.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Typical limitations include: (a) time limitation; (b) *de minimis*; (c) claim threshold; or (d) cap for the liability amount.

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6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

It is not common. However, the buyers may obtain a bank comfort letter or other proof of fund documentations.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

The private equity buyers may show a bank comfort letter to show the finance ability of the private equity buyers. In the agreement, the sellers usually set out some kind of liquidated damages to cover the non-payment of the commitments by the buyers.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

These are not common in Indonesia.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

The Indonesian government provides quite strict regulation for a company to be able to conduct an IPO. The main challenges in order to conduct an IPO include the long process of the registration statement, thorough verification by the authority, minimum floating, lock-up for founder shares and shares resulting from the debt equity conversion.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

If the private equity sellers obtain the shares (within the period of six months prior to the submission of the registration statement to OJK) with a lower price than the IPO's price, then such shares will be locked up until eight months after the effectiveness of the registration statement to the OJK.

Further, if the private equity sellers obtain the shares during the IPO by converting its convertible bonds issued by the target, the shares could not be traded in the stock exchange for one year after the conversion.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Based on our understanding, the dual-track exit process here means that the private equity company plans to exit by conducting an IPO while also pursuing a possible M&A exit at the same time. In that case, this method is common in Indonesia.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Utilisation of debt to fund private equity transactions is not common in Indonesia.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

The laws and regulations prohibit the use of debt for injection of capital for some line of businesses, such as multi-finance companies and venture capital companies. In addition, banks are also prohibited from granting loans to an individual or to a company other than securities companies if the loan is used for the purpose of shares trading.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

The current trends in debt financing include factoring receivables facilities given by some financiers.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

The key consideration for private equity investors and transactions would be the most efficient tax exposure when the private equity exits from its investment and when the return from the investee is repatriated to it. The private equity would normally concern the tax treatment for the dividend, interest and royalty payment and the exit scheme.

Off-shore structures are also common (as explained in question 2.1 above).

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Management teams should consider the maximum tax treaty benefit that they will receive so that they can exit the investment with the lowest tax exposure. In between the investment and the exit, they should wisely choose the jurisdiction of the investee and the beneficial owner, so that they can get the lowest corporate tax rate pursuant to the tax treaty.

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9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

The key tax consideration must be the capital gain tax for the transfer of the shares in the jurisdiction of investee and investor. Further, the management teams would seek that the new acquisition structure has a better tax treaty benefit for the private equity investor. The management team should also consider the minimum amount of shares percentage in the investee that they need to maintain in order to have the lowest withholding tax rate for the dividend payment.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

Here are the changes in tax legislation which might impact private equity investments:

- The Minister of Finance sets out the debt-to-equity ratio that will be considered in the calculation of income tax in 2015. Pursuant to this regulation, the maximum allowed debt to equity ratio is 4:1.
- The Minister of Finance sets out transfer pricing regulation and country-by-country report (**CbCR**) to combat tax avoidance and BEPS practices in Indonesia. Pursuant to this regulation, a taxpayer who conducts a transaction with affiliated parties must maintain some kind of documentation and information to be reported to the authority. To supplement this regulation, the DGT just issued a new regulation concerning the classification of the taxpayers required to submit the CbCR and the procedures for the submission.
- The Minister of Finance signed a Multilateral Competent Authority Agreement on 3 June 2015. Following the signing of this agreement, the Automatic Exchange of Information with 94 other jurisdictions will automatically apply in September 2018.
- Regulation of the Minister of Finance No. 258/PMK.03/2008 regarding Withholding of Income Tax regulates that a transfer of shares of a company which was established in a tax haven country and has a special relationship with an Indonesian company or permanent establishment in Indonesia is subject to 20% of the estimated net sales amount.
- Regulation of Directorate General Taxation No. PER-25/PJ/2018 regarding the Guidelines Prevention on the Abuse of Double Taxation Avoidance regulates that in order to not be classified as abusing the double taxation avoidance, the foreign tax subject shall fulfil some criteria, among others having: (i) economic substance in the establishment of entity and performance of transaction; (ii) active business activities; and (iii) assets.
- The President of the Republic of Indonesia has just issued Perpres No. 13 of 2018 which concerns the beneficial owner of legal entities in Indonesia. This regulation focuses on, amongst other things: (a) the criteria of a beneficial owner; (b) the reporting; and (c) the possibility of automatic exchange of information with another institutions, either nationally or internationally. Even though the purpose of this regulation is to combat terrorism and money laundering, many believe that this will impact taxation and transfer pricing activities as well, seeing as the beneficial owner is one of the most important factors in determining tax avoidance or illegal transfer pricing practices.

Learning from the google tax case in Indonesia, the government has issued circular Letter of Minister of Communications and Informatics No. 3 of 2016 regarding the Service Provision of Application and/or Content Through the Internet (Over The Top or **OTT**) – attached herein, for your reference – which regulates that an OTT provider needs to establish a permanent establishment in accordance to the prevailing tax laws and regulations. This is for the purpose of, among others, tax payment for the income generated in Indonesia.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

In order to gain more interest of investors in general, the government has tried to make investing in Indonesia as simple as possible. To support this, they issue new regulations establishing an online integrated system for the application of licences in Indonesia called the Online Single Submission (**OSS**) – as regulated under Government Regulation No. 24 of 2018. This OSS system replaces the registration process to the Investment Coordinating Board (**BKPM**), except for certain lines of businesses which are still handled by the BKPM.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

Indonesia regulates certain maximum shareholder percentages which are closed for foreign investment, as regulated under Regulation of the President of Indonesia No. 44 of 2016. Some lines of businesses which are deemed important for the country are listed as prohibited for foreign investment.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

The scope of due diligence usually depends on the value of the transaction and the industry of the target. If the value is high, the investor usually requires a full-blown due diligence covering corporate documents, licences, manpower, agreements with lenders, suppliers and customers, assets, insurances, environmental compliance, litigation and court searches. On the other hand, if the value of the transaction is not material, the investor usually requires only a limited due diligence that covers only corporate documents, licences, assets, and material agreements.

The investor usually engages an Indonesian counsel to conduct the due diligence process.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Normally, yes. The jurisdiction of the investor would determine the risk appetite of the investor in this regard. Investors coming from a country with very strict anti-bribery protection like the U.K., U.S. or Japan would be very concerned about this.

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10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Generally, shareholders of an Indonesian company would not be held liable for the company's losses beyond the value of the shares they held.

In theory, a "piercing" of the limited liability veil may take place if it can be proven that certain shareholders unlawfully squandered the company's assets such that the company is unable to meet its obligation. The risk to the private equity investor is, however, quite low.

The risk to other portfolio companies is even more unlikely because, normally, the investor would create a separate SPV to hold shares or interests in each of the portfolio companies, reducing the risk of lateral exposure of debts from other portfolio companies to remote at best.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Some minor concerns that the investors might need to consider are:

- Any agreement with an Indonesian party would need to be translated pursuant to Article 31 of the Law on Flag, Language, Emblem and National Anthem.
- Law No. 13 Year 2003 (**Labour Law**) contains several provisions that may adversely impact private equity investment in a company, including:
  - In the event of a change of a company's status, merger, consolidation or a "change of ownership" (frequently associated with a change of the controlling shareholder, but a change in the management's policies regarding employees' rights and entitlements may also qualify for a change of ownership), its employees would have the right to choose whether to remain or to terminate their employment with the company (Article 163(1) of the Indonesian Labour Law), in which case severance entitlement could be payable. However, recently there has been a Judicial Review Decision from the Constitutional Court under Decision No. 117/PUU-X/2012 deciding that the right of termination is in the hands of the employer, meaning that the employer is the one to decide whether to terminate or not. The right of the employee to decide not to continue the employment relationship in the event of a change of ownership is conditional only if there is a re-structurisation, rotation, reposition, inter-department transfer (*mutasi*), promotion, demotion, and change of working conditions of the employee. If there is no such condition, the employer may reject the request of termination and the employee will be deemed to have voluntarily resigned from the company. However, our research with the Ministry of Manpower to discuss this issue indicates that given that the term "may", as stipulated in Article 163, is vague, the mediator and Industrial Relations Court may have different interpretations on this clause.
  - Under Article 163(2) of the Labour Law, the employer has the right to dismiss employees only in the event of a change of the company's status, merger and consolidation, but not in the event of a "change of ownership".
- Some joint ventures may be subject to mandatory merger control requirements (Article 28 of Law No. 5 of Year 1999 (**Anti-Monopoly Law**)).
- Rupiah must be used in certain cash and non-cash transactions occurring in the territory of Indonesia (Bank Indonesia Regulation No. 17/3/PBI/2015).
- The government has issued a new regulation establishing an online integrated system for the application of licences in Indonesia called the *Online Single Submission* – as regulated under Government Regulation No. 24 of 2018.

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Freddy Karyadi has over two decades of experience practising law in Indonesia and has been heavily involved in numerous complex cross-border deals including project financing, M&A, tax, capital market, investment, and dispute settlement/bankruptcy.

Karyadi was one of the pioneers who focused on the digital industry and has handled many transactions involving technology and FinTech/TMT companies, from early stage fundraising, integration, exit, public offering preparation to regulatory compliance. Karyadi has represented independent power producers, giant ECAs and commercial banks for various electricity sector financing. Karyadi's clients vary from multinational to start-ups which span across a wide range of industries including natural resources, energy, financial institutions, private equity funds, and property. With a strong knowledge of legal, commercial, tax and accounting issues that these industries encounter, Karyadi can quickly identify the key issues and offer practical business oriented legal solutions.

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Karyadi has been consistently rated as a leading lawyer by several international publications including *Asialaw*, *The Legal 500* and *IFLR1000*.

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Ms. Anastasia Irawati joined ABNR as an associate in January 2012. She graduated with honours in 2011 from the Faculty of Law of the Parahyangan Catholic University. In 2016, she earned a Master of Laws (LL.M.) degree from New York University (NYU) School of Law, majoring in corporations law. During her studies at NYU, she gained exposure to U.S. legal practice by participating in the mediation of real disputes in a variety of cases within the New York State court system (including landlord-tenant disputes, loan disputes, auto accidents, work contracts and unpaid bills) alongside coaches and mediation supervisors.

At ABNR, she has been part of the teams of lawyers that assist clients in general corporate, antitrust, intellectual property rights, pharmaceutical and food industry matters as well as in commercial litigation. She has ample experience in handling start-up entrepreneur cases and has been involved in projects relating to restructuring, suspension of payment, investment and acquisition. She also contributes articles to *Getting the Deal Through*, *Lexis Nexis* and *Thomson Reuters*.

COUNSELLORS AT LAW

As Indonesia's longest-established law firm (founded 1967), ABNR pioneered the development of international commercial law in the country following the reopening of its economy to foreign investment after a period of isolationism in the early 1960s.

Today, we believe our legal expertise and experience is second to none, as vouchsafed by our recent confirmation as the exclusive Indonesia member firm for Lex Mundi (the leading global network of independent law firms) for a further period of six years.

With over 100 lawyers, ABNR is the largest independent, full-service law firm in Indonesia and one of the country's top-three law firms by number of fee earners, which gives us the scale needed to simultaneously handle large and complex transnational deals across a range of practice areas.

We continue to value the personal touch and are proud of our reputation for responsiveness. Our lawyers are business-savvy and fully understand that – alongside legal expertise and experience – timeliness and value for money are of the utmost importance to our clients.

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Ireland

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

A broad range of private equity ("PE") transactions are carried out in Ireland, the most common including leveraged buyouts, refinancings, trade sales, bolt-on deals and secondary buyouts.

The volume of PE transactions increased in 2018. A noticeable trend over the last 12 months has been the increase in the number of secondary buyouts which historically had not been a common feature of the Irish PE landscape.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Ireland delivers:

- a low corporate tax rate – corporation tax on trading profits is 12.5% and the regime does not breach EU or OECD harmful tax competition criteria;
- the regulatory, economic and people infrastructure of a highly-developed OECD jurisdiction;
- the benefits of EU membership and of being the only English-speaking jurisdiction in the eurozone;
- a common law jurisdiction, with a legal system that is broadly similar to the US and the UK systems;
- refundable tax credit for research and development activity and other incentives; and
- an extensive and expanding double tax treaty network, which includes over 70 countries, including the US, UK, China and Japan.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

Irish economic growth is expected to continue in 2019 – the Central Bank of Ireland has recently forecasted economic growth of more than 4% this year, which follows growth of more than 5% in 2018. This means that Irish businesses will remain attractive to both local and international PE investors. The competition between investors will likely lead to more flexibility from PE funds in terms of both the structure and terms of transactions, with minority investments becoming more common.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

PE transactions are usually structured using a holding company ("Holdco") and an indirect wholly-owned subsidiary of Holdco ("Bidco"). Holdco is commonly owned by the PE fund and management, as majority and minority shareholders, respectively. Holdco can take the form of an offshore vehicle, although it is usually Irish or UK tax resident.

Bidco's primary role is to acquire and hold the target's shares and it may also act as borrower under the debt facilities. For tax- and/or financing-related purposes, it is common to have intermediate holding companies inserted between Holdco and Bidco.

For inbound investments, Bidco is typically a private limited liability company resident, for tax purposes, in Ireland. The jurisdiction of incorporation of Bidco can vary and may be onshore or offshore.

2.2 What are the main drivers for these acquisition structures?

There are a number of factors which affect the acquisition structure adopted in PE transactions. These drivers include: (i) the tax requirements, capacity and sensitivities of the PE house, management and target; (ii) the finance providers' requirements; and (iii) the expected profile of investor returns.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

PE investors typically use small proportions of equity finance to subscribe for ordinary or preferred ordinary shares in Holdco. The balance is generally invested as a shareholder loan (often structured as loan notes issued by Holdco), or preference shares.

Management will generally subscribe for ordinary shares in Holdco representing between 5% and 15%, commonly referred to as "sweet equity". On some buyouts, key senior management with sufficient

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funds to do so may also be permitted (and/or required) to invest in the institutional strip.

Senior management are usually expected to make sufficient financial investment in the target group to ensure their interests remain aligned with the PE investor and that they remain incentivised to create further value. They will also typically sign up to contractual restrictions (see question 2.5 below).

Other key personnel may be invited to participate in management incentive plans or to become additional employee shareholders.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Typically a PE investor taking a minority position will invest directly through an existing entity rather than investing through a newly established Irish special purpose vehicle. A minority PE investor will typically be more focused on veto rights, given it is unlikely to have board control. Depending on the size of the stake, vesting periods for management shares, good leaver/bad leaver provisions may be somewhat relaxed.

From a tax structuring perspective, the availability of Ireland's "substantial shareholders" exemption should be borne in mind in the context of minority investments, as this relief from Irish capital gains tax ("CGT") only applies where a minimum 5% shareholding has been held for a particular holding period. Further detail on the "substantial shareholders" exemption is contained at question 9.1 below.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

See question 2.3 for the typical range of equity allocated to the management.

Transaction documents will invariably include provisions enabling the PE fund to compulsorily acquire a manager's shares on termination of his/her employment with the relevant portfolio company.

Documentation will usually include good leaver/bad leaver provisions, which will determine the amount payable to the departing manager. See question 2.6 for further information on good leaver/bad leaver provisions.

A "good leaver" will commonly obtain the higher of cost and fair market value for his/her shares while a "bad leaver" may expect to receive the lower of fair market value and cost. The documentation may also contain clawback provisions whereby an individual who has been treated as a "good leaver" but subsequently breaches, for example, restrictive covenants or other material provisions of the relevant documentation, will be required to reimburse the "good leaver" portion of the proceeds received by him or her.

The relevant documentation may also include vesting provisions that will regulate the proportion of shares for which the departing employee will be entitled to the "good leaver" price (i.e. higher of cost and fair market value) by reference to the length of the period from buyout to termination. Vesting may be straight-line or stepped and full vesting may typically occur after a period of between three and five years.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

As the competition for suitable assets has increased in parallel with the general increase in PE activity in Ireland, an increasingly common approach taken by PE funds is to have more management friendly leaver provisions whereby a "bad leaver" is defined by reference to specific circumstances (voluntary resignation, termination for gross misconduct, etc.), with all other circumstances constituting a "good leaver".

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

PE houses and management will typically enter into a shareholders' agreement to govern their relations as shareholders in the portfolio company. This will likely include, among other provisions: (i) covenants from management with regard to the conduct of the business of the portfolio company; (ii) extensive veto rights for the PE house; (iii) restrictions on the transfer of securities in the portfolio company; and (iv) provisions regarding further issuances of shareholder equity/debt.

In addition, the constitutional documents may include governance arrangements, particularly with regard to the transfer of shares and the appointment of directors.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

PE investors normally enjoy significant veto rights over major corporate, commercial and financial matters, although thresholds are commonly set to ensure that day-to-day decisions can be taken by management.

These veto rights will typically be split between director veto rights and shareholder veto rights.

In a minority PE investment, given the PE house is unlikely to have board control, the PE house is typically much more focused on veto controls and in particular around new equity/debt issues, budget control and acquisitions and disposals.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

Veto rights will generally be respected by Irish courts, but may be found to be void if they constitute an unlawful fetter on any statutory powers of an Irish company or are contrary to public policy. Generally, appropriate structures can be put in place to ensure that customary veto rights are effective.

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A shareholders' agreement is likely to be entered into to ensure that agreed veto arrangements would be upheld at the shareholder level. Such an agreement may also oblige the shareholders to procure that certain actions are taken (or not taken) by the relevant target group companies.

Directors' veto rights need to be balanced with the directors' duty to act in the best interests of the portfolio company. Hence, it is wise to retain shareholder level veto rights.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

The PE investor itself is not subject to fiduciary or other duties under Irish company law to the minority shareholders (but see question 3.6 below for potential liability as shadow director). Board nominees generally owe duties to the company, but may, in limited circumstances, owe duties to shareholders (for example, regarding information disclosure).

Certain duties may also be owed if: (i) the portfolio company is insolvent or verging on insolvency; or (ii) if a specific special relationship (for example, principal and agent) is established between the nominee directors and the shareholders.

Shareholders may be entitled to bring derivative actions on behalf of the company against the nominee directors (often as a last resort), although it may be difficult to establish the eligibility of the shareholders to bring such an action under company law.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Save to the extent that they contravene statute or are contrary to public policy, there are no such limitations or restrictions that would apply with respect to an Irish company as regards enforceability. However, if the group structure includes companies from other jurisdictions, the impact of the laws of those jurisdictions will need to be considered. Non-complete restrictions will only be enforced to the extent reasonable in terms of geographical, temporal and sectoral scope. Governing law clauses which set non-Irish law as the law of choice will typically be respected by the Irish Courts.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

PE investors must ensure that nominee directors are eligible to act as directors, including, in particular, that they are not disqualified by statute or restricted from so acting under Irish company law.

In the context of being entitled to nominate directors, PE investors ought to be aware that in certain circumstances they may be construed as "shadow directors" under s. 221 of the Companies Act 2014 ("CA"), if the nominee directors are accustomed to act according to the directions and instructions of the PE fund. If construed as shadow directors, the PE investor would be treated as a director of the portfolio company and directors' duties would apply to it.

Nominated directors risk incurring liabilities if they breach their directors' duties (including their statutory duties under ss. 223–228 CA) and may face the risk of clawback action for certain decisions made during certain periods of time if the company is insolvent or verging on insolvency.

PE investors will typically seek to mitigate the impact of the above risks through directors' and officers' insurance policies.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Such directors must be mindful that although they are nominee directors, their duties are generally owed to the company itself and not to the party nominating them or other shareholders.

The CA (s. 228(i)(f)) imposes a duty on a director to "avoid any conflict between the directors' duties and…other interests unless the director is released from his or her duty to the company…". Such an actual or potential conflict of interest may arise, for example, with respect to (i) the nominating PE house, or (ii) the directors' other directorial positions.

A specific release passed in a general meeting or included within the portfolio company's constitution in relation to any matter of concern would reduce this list.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

The timing for transactions is largely affected by regulatory approvals, mainly competition or other sector-specific approvals. For instance, a number of PE funds have invested in regulated financial services (including insurance) companies in the last 12 months which have been subject to the prior approval of the Central Bank of Ireland – see further question 10.2. The time required to prepare suitable financial statements (particularly given the prevalence of locked-box-pricing mechanisms in PE transactions) can also impact significantly on timing.

4.2 Have there been any discernible trends in transaction terms over recent years?

The M&A landscape remains generally favourable to PE sellers in Ireland. Recent trends include: (i) continuing prevalence of the "locked-box" consideration structure; (ii) increase in deals involving warranty and indemnity insurance; (iii) continuing limited representation and warranty protection from PE sellers; and (iv) reducing limitation of liability periods.

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5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

In public-to-private transactions involving Irish companies, the Irish Takeover Rules ("Takeover Rules") will usually apply. The Takeover Rules regulate the conduct of takeovers of, and certain other transactions affecting, Irish companies listed on certain stock exchanges, and contain detailed provisions covering matters such as confidentiality, announcement obligations, deal timetable, capped break fees and public disclosure. The Takeover Rules are administered by the Irish Takeover Panel (the "Panel"), which has supervisory jurisdiction over such transactions.

While the application of the Takeover Rules means that such transactions are generally subject to a more restrictive framework than a typical private company transaction, there are three particular Takeover Rules features of note:

- A transaction must be independently cash-confirmed before a bidder can announce a firm intention to make an offer. For a PE investor, this means that, at the time of announcement, its funding will need to be unconditionally available to the bidder (including possibly being placed in escrow).
- Once a firm's intention to make an offer is announced, a bidder will generally be bound to proceed with the offer. Furthermore, save for the acceptance condition or any competition/anti-trust condition, once an offer is made, the bidder will have limited scope to invoke any other condition to lapse or withdraw the offer. This increases the importance of due diligence for the PE investor.
- Special arrangements with any category of target shareholder, including management incentivisation proposals, will generally require Panel consent. Such consent may be given subject to independent shareholder approval at a general meeting. This necessitates the importance of early formulation of such arrangements or proposals and engagement with the Panel.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

Break fees are allowed in relation to public acquisitions with Panel consent. The Panel will typically only consent to break-fee arrangements of up to 1% of the value of an offer, with limited trigger events, including: (i) the withdrawal of an offer recommendation by the target board resulting in the offer being withdrawn or lapsing; or (ii) the success of a competing offer. The mere failure to achieve a minimum acceptance level in the absence of (i) or (ii) would not typically be an acceptable trigger for payment of a break-fee.

The target can also agree not to shop the company or its assets, subject to consideration of the fiduciary duties of the directors.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

"Locked-box" structures are generally preferred by PE sellers as they offer certainty in the purchase price from the outset, greater control over financial information, potentially reduced contractual liability, cost savings and prompt distribution of sale proceeds to investors/sellers after completion. The buyer will be compensated for any "leakage" of value from the target group following the "locked-box date" (save to the extent the parties agree such leakage is to be treated as "permitted" (and so not to form the basis of any adjustment)).

Other consideration structures commonly used may involve adjustments by reference to working capital and net debt. These structures rely on a statement or set of accounts drawn up shortly after completion and adjustments are made to the purchase price based on deviations from reference balance sheets/accounts, drawn up prior to execution of the share purchase agreement (and on which the pricing has, in theory, been based).

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

A PE seller usually only provides warranties regarding title to its own shares, capacity and authority.

The target's management will often (subject to their percentage ownership and on the basis they are usually better placed to) provide business warranties, under a separate management warranty deed. The key rationale for the warranties is generally to elicit full disclosure regarding the target during the due diligence process, although the negotiated warranty package may form the basis for warranty and indemnity insurance protection.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

A PE seller will usually provide pre-completion undertakings in relation to no-leakage (in a locked-box pricing structure) and assistance with regulatory filings and, in some cases, undertakings regarding the conduct of the target business pre-completion (although frequently limited to exercise of voting in a manner aimed at achieving such outcome rather than an absolute procure covenant).

A PE seller is very unlikely to provide non-compete covenants, but these may be provided by members of management who are exiting the target business. Typically non-solicitation of employees covenants will be acceptable to a PE seller.

Management will also generally provide pre-completion undertakings regarding the conduct of the target business pre-completion.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Buyer warranty and indemnity insurance policies are increasingly obtained and preliminary terms for buy-side insurance are commonly included by PE sellers as part of the initial sell-side transaction documentation, for buyer and insurer to agree during negotiation of the sale and purchase documentation.

These will typically be given on the basis of a set of business warranties given by management, but subject to limitations designed to ensure that personal liability of management is limited.

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A policy will usually be subject to excess limits and sellers or management can often be asked to bridge some or all of that gap. Excess limits tend to be between 0.5% and 1% of the enterprise value of the target.

Some market standard exclusions applied by insurance providers include coverage for criminal fines and penalties, pollution/contamination, fraud, dishonesty and deliberate non-disclosure of the policyholder.

Subject to minimum premium amounts, premiums tend to be broadly between 1% and 1.5% of the insured limit.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

On the basis that a PE seller's warranties will generally be limited to title, capacity and authority, a PE seller's warranties are usually either subject to a cap equal to the aggregate purchase price or uncapped.

Liability under any "no-leakage" covenant will likely be limited to a relatively small amount which is commonly escrowed.

Managers can limit their liability under the warranties by: (i) giving them severally (each manager is only liable for its proportionate share of liability for any claim and/or its own breach) and subject to awareness; and (ii) capping maximum liability for any warranty claims.

In a transaction including warranty and indemnity insurance, the cap on management liability for warranties will often be set at the level of the insurance deductible/excess.

General limitations include time limits within which claims may be brought, and *de minimis* and basket thresholds.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Escrow retention accounts do feature in some transactions but PE sellers typically look to resist such arrangements. This is particularly true as the prevalence of W&I insurance on transactions increases. PE buyers will regularly look to have escrow accounts for management warranties but again, this trend is evolving in line with the increasingly flexible W&I insurance market.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

The PE fund usually gives a direct commitment to the seller to fund Bidco with the equity capital committed to the transaction, subject only to the satisfaction of the conditions in the share purchase agreement and financing being available. The seller can generally enforce this commitment directly against the PE fund to the extent it becomes unconditional and the PE fund fails to fund Bidco.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are unusual in PE transactions in Ireland.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

Typically, an Irish IPO will be part of a dual-listing with either a UK or US listing. There are a number of key issues which need to be considered by PE sellers considering an IPO exit, including the following:

- Market risk: unlike certain other PE exit routes, PE sellers are exposed to market risk when looking to access institutional investor capital through an IPO process. Sellers can look to mitigate this risk by commencing a pre-marketing campaign earlier in the deal timeline to try and secure a successful outcome (equally, however, this means that if there is a need to postpone the transaction for whatever reason, it can be seen as a more significant failure by the investor community).
- Lock-ups/selling restrictions: PE sellers may not be able to dispose of their stake in the business completely at the time of the IPO. PE sellers may be subject to a lock-up period during which they would be unable to sell some, or all, of their stake in the business to prevent detrimental effects on the valuation of the company immediately after the IPO. As such, there would be a delay between the time of the IPO and the time at which the PE fund would fully realise its investment. Please see the response to question 7.2 for further commentary on the duration of lock-ups.
- Contractual obligations relating to the IPO: the PE seller will be required to be a party to the underwriting agreement entered into with the investment banks underwriting the IPO. The PE seller will be expected to give a suite of representations and warranties to the banks as to a range of matters relating to itself and the shares it owns and, to a more limited extent, the company being floated and its business. It will also be expected to give the underwriting banks a broad transaction indemnity covering any losses they may incur in connection with the transaction.
- Corporate governance: on the IPO, depending on the listing venue, companies are often required to adopt a particular corporate governance framework. Therefore, whilst the PE seller may have enjoyed contractual rights to board representation and other matters prior to the IPO, these are likely to be significantly constrained on completion of the IPO (please see further the response to question 7.3 below).

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

The duration of the lock-up provided by the PE seller will vary from transaction to transaction, but is typically for a period of six months following the IPO. As a result, the PE seller will be exposed to market risk for the duration of the lock-up period in respect of any stock it retains, with no ability to sell if the market begins to turn or the company's performance declines.

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7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Almost all Irish transactions in recent years have concluded through a sale rather than an IPO. Typically, a PE seller looking to exit by way of an IPO will look to an IPO by way of a dual-listing in Ireland and either the US or UK.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Traditional bank-led leveraged loan financing remains the most common source of debt finance used to fund both mid-market and large PE transactions in Ireland.

However, in recent years, there has been increasing competition between traditional bank lenders and non-bank (or "alternative") lenders and funds, which has resulted in a wide array of other debt products being offered to market participants to replace and/or supplement traditional senior secured bank loans. These include term loan B ("TLB") facilities, mezzanine and unitranche loans and second lien loan products. For certain transactions, some market participants have also been able to turn to direct lending funds.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

There are no particular legal requirements or restrictions that would affect the choice or structure of debt financing of PE transactions in Ireland generally. However, market participants should be aware of, and ensure compliance with, any industry specific laws and regulations, as well as the broader regulatory regime affecting PE transactions.

For example, market participants need to be especially careful in regards to compliance with anti-bribery, corruption and sanctions laws. Aside from local laws, borrowers and sponsors should also be aware of the expansive nature and potential extraterritorial reach of such laws and regulations in the US, which can necessitate compliance by many non-US entities (or entities that have only limited US ties).

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

The availability of credit continued to increase in 2018, particularly for businesses engaged in commercial real estate. The source of this credit, however, has continued to shift away from traditional lenders to a mixture of banks, mezzanine lenders and non-bank lenders. After the financial crisis, increased regulatory pressure on banks as a whole to deleverage and reduce their loan books left a liquidity gap in the market, which non-bank lenders took advantage of.

The most significant effect on the Irish loan market will undoubtedly be Brexit. It is impossible to predict exactly how the loan market in Ireland will be affected by the planned exit of the UK from the EU.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

When investing in an Irish target, key tax considerations for PE investors will include the choice of holding structure, transaction tax costs, debt financing considerations, and the management of tax costs on the flows of cash from the portfolio companies.

In terms of Ireland as a holding company jurisdiction, Ireland offers an attractive tax regime for holding companies. Irish holding companies can receive dividends from their Irish subsidiaries tax-free and from foreign subsidiaries on an effective Irish tax-free basis (or with a very low effective rate of Irish tax). This is due to a combination of Ireland's low corporation tax rate and the availability of Irish credit relief for foreign taxes.

Ireland's "substantial shareholders" exemption relieves Irish holding companies from Irish CGT on the disposals of subsidiaries. Two main conditions apply: (a) the subsidiaries must be resident in the EU or in a country with which Ireland has a tax treaty; and (b) a minimum 5% shareholding must have been held for a continuous period of at least 12 months within the previous 24 months.

There are broad exemptions from Irish withholding taxes on dividends, interest and royalties, including exemptions for payments to persons resident in tax treaty countries (and additionally, in the case of dividend payments, to companies controlled by persons resident in tax treaty countries).

Ireland has no controlled foreign company ("CFC") rules and no general thin capitalisation rules.

In terms of transaction tax costs, this can depend on how the investment is structured. Where the target is an Irish incorporated company, an Irish stamp duty cost will generally arise upon the acquisition, at a rate of 1% on the consideration paid (or market value, if higher), depending on how the investment is structured. For certain real estate holding companies, the stamp duty rate can be higher.

In terms of share acquisitions generally, appropriately structured, an interest deduction should be available for interest paid by an Irish holding company in connection with an acquisition of shares (subject to certain conditions being satisfied). Provided certain conditions are met, this tax deduction can be offset against the profits of the Irish target group. Appropriately structured, Irish withholding tax on the payment of interest can be reduced or eliminated.

As alluded to above, Ireland is also an attractive holding company location for PE investments outside Ireland.

Finally, Ireland has a beneficial tax regime applying to Irish domiciled investment funds (which can provide an attractive holding structure for PE investors).

Ireland is widely recognised as one of the world's most advantageous jurisdictions in which to establish investment funds. Our investment funds offering was bolstered in 2015 by the introduction of the Irish Collective Asset-management Vehicle ("ICAV"). The ICAV is a corporate entity that is able to elect its

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classification under the US "check the box" tax rules. Irish domiciled funds have a variety of attractive tax attributes, in particular that income and gains can accumulate free of Irish tax within the fund and that returns can be paid to non-Irish investors free of Irish tax provided certain declarations are in place. The ICAV has great potential in the context of PE transactions.

As regards whether offshore structures are common, in short, it depends. Given the attractive features of Ireland's holding company regime as set out above, Irish structures often feature. However, that said, we do see offshore structures used from time to time, the choice of structure depending on the factors set out in the first paragraph above.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

In general, whilst share incentivisation is common in Ireland, the tax treatment of most forms of share incentivisation is not particularly advantageous for employees/directors based in Ireland, with marginal rates of income tax, universal social charge and social security generally applying on any benefits obtained (subject to the comments below). However, if the shares that the employees receive qualify as "restricted shares" (under Irish tax rules), there could be a material abatement of up to 60% of the taxable value of the shares for Irish tax purposes (subject to certain qualifying conditions being met). This is, potentially, very favourable for employees/directors. Ireland has also introduced a "Key Employee Engagement Programme" ("KEEP") which provides for an exemption from income tax, universal social charge and social security arising on the exercise of a qualifying share option to acquire shares in a qualifying company in the SME sector provided certain conditions are satisfied.

Ireland has a specific tax regime for the return (known as "carried interest") received by venture capital managers for managing investments in certain venture capital funds. The regime operates by treating certain carried interest received by a partnership or a company as being subject to chargeable gains and applying a reduced rate to such carried interest. The share of profits which benefit from the reduced rate must relate to an investment in a trading company, which remains in place for at least six years and carries on qualifying "research and development" or "innovation activities", and satisfies certain additional conditions.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

A key tax consideration for management teams based in Ireland will be to ensure that any shares acquired as part of a roll-over will consist of an investment acquired in their capacity as a shareholder in the target or acquisition structure, and not in their capacity as an employee (and be documented as such), in order (as appropriate) to avail of CGT rates on the return on the investment (and not the marginal rates of income tax, universal social charge and social security).

Management teams will also be keen to ensure that "share-for-share" CGT relief will be available (where preferable) in order to defer any potential CGT in respect of the disposal of their holding in the target.

Stamp duty roll-over relief may also be relevant in the context of Irish target companies.

On an ongoing basis, the potential to avail of employee incentives such as the special assignee relief programme ("SARP"), and the foreign earnings deduction ("FED"), and any tax reliefs in the context of share awards will also be relevant.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

The ongoing implementation of the Anti-Tax Avoidance Directive ("ATAD") rules over the coming years in Ireland will require ongoing consideration in the context of PE investments.

Under Council Directive (EU) 2015/2376, Member States are required to exchange tax rulings issued in respect of certain "cross-border transactions" on a quarterly basis. This took effect in Ireland from 1 January 2017. In addition, Irish Revenue have issued new guidance on the validity period of opinions/confirmations issued by Irish Revenue, which are stated to be subject to a maximum validity period of five years, or such shorter period as may have been specified by Irish Revenue when providing the opinion/confirmation.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

The AIFMD has resulted in PE funds which operate in the EU becoming subject to additional regulation. In relation to PE transactions, the new regulation imposes new disclosure requirements in relation to portfolio companies and new restrictions on the ability of PE fund buyers to release assets from portfolio companies (the so-called "asset-stripping" rules). These obligations apply to all PE funds that are managed within the EU and also any PE funds that are marketed to investors in EU Member States pursuant to the AIFMD private placement regimes.

There is a requirement on an Irish body corporate or other legal entity to maintain its own register of beneficial owners. This register will list the individuals who ultimately own or control a legal entity through direct or indirect ownership of more than 25% of the shares or voting rights or ownership interest in that entity. Secondary legislation to formally establish a central beneficial ownership register to meet Ireland's obligations under the EU Fourth and Fifth Anti-Money Laundering Directives, has now also been signed into law. In addition to the requirement to have its own register of beneficial owners, from 22 June 2019 certain information must also be filed on a central register. Companies will have a period of five months from 22 June 2019 to make their first filings at the central register. In terms of access to information filed on the central register, the public may access it but access will be restricted to certain content only and it should be noted that personal identifier numbers and residential addresses will not be made available to the public. Competent Authorities such as the police and financial intelligence units will have wider access.

From 1 January 2019, only mergers where the acquirer and target each generate €10 million (or more) and together generate €60 million (or more) of turnover in Ireland will trigger mandatory notification in Ireland. The previous thresholds were €3 million and €50 million, respectively.

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10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

Some sectors have special rules. In particular, if the transaction relates to the purchase of a business regulated by the Central Bank of Ireland ("CBI"), the proposed PE investors cannot acquire a qualifying holding in the regulated firm without first notifying the CBI and obtaining the pre-approval before the acquisition can take place. A "qualifying holding" is either a direct or indirect holding in a regulated firm that represents **10%** or more of the capital of, or the voting rights in, the firm, or that makes it possible to exercise a significant influence over the management of that firm. Media mergers are subject to approval of the CCPC and the Minister for Communications, Climate Action and Environment and Irish airlines are subject to foreign control restrictions.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

The level of legal due diligence will vary from transaction to transaction. Typically, diligence will be conducted over a three to six-week period. Materiality thresholds will vary from sector to sector but in a business with a small number of key contracts, a PE buyer may set no materiality threshold on those key contracts.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

PE sellers are increasingly concerned with compliance with anti-corruption/bribery legislation principles, particularly given increasing regulatory scrutiny of corporate conduct and potentially significant financial penalties and reputational damage resulting from non-compliance. Typically, this concern is addressed by warranty protection regarding compliance with such laws.

The Criminal Justice (Corruption Offences) Act 2018 was enacted in 2018. This introduces a new corporate liability offence which allows for a corporate body to be held liable for the corrupt actions committed for its benefit by any director, manager, secretary, employee, agent or subsidiary. The single defence available to corporates for this offence is demonstrating that the company took "all reasonable steps and exercised all due diligence" to avoid the offence being committed.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Generally, an Irish court will not "pierce the corporate veil" so as to impose liability on a shareholder for the underlying activities/liabilities of its subsidiary/investee company, provided the portfolio company is a limited liability company. If an unlimited company or partnership is used, its shareholders/partners can be liable for the entity's debts.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Ireland provides an economically attractive venue for PE investment and PE industry. There are attractive tax structuring options for non-Irish PE investors (e.g. the ICAV structure). See section 9 above.

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Brian acts for clients across the full investment spectrum including target companies, venture and growth capital providers, private equity sponsors and management teams. In addition to his transactional practice, he advises clients on general commercial matters and business-related issues, including providing strategic investment advice. He regularly works with Irish companies undertaking transactions outside of Ireland.

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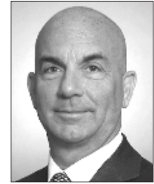
Italy

Nathalie Brazzelli



Pirola Pennuto Zei & Associati

Massimo Di Terlizzi

1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

A broad range of private equity transactions are carried out in Italy. The most common transactions are leverage buyout acquisitions, refinancing, bolt-on deals and secondary buyouts.

Despite the uncertain political situation, there have been no material changes in the last two to three years.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Italy has a wide range of medium-size companies (which are often worldwide, successful entrepreneurial cases) and companies with good growth and development potential. This, combined with the high standards of the management, makes Italy an attractive marketplace.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

For the next 12 months the interest of private equity in Italian transactions should be stable and reflect the previous year's trend.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Private equity transactions are generally structured using a holding company ("Topco") and a wholly owned subsidiary of Topco ("Bidco").

Topco is usually owned by the private equity fund.

Bidco, which is usually incorporated as an Italian limited liability company (s.r.l.) or stock company (s.p.a), acquires the Target shares and also acts as borrower under the debt facility. The Italian Bidco is merged with the Target post-closing in order to allow the debt pushdown.

Top management commonly co-invest at Topco or Bidco level.

2.2 What are the main drivers for these acquisition structures?

The private equity structures are generally designed in order to: i) allow the interest expenses deduction; ii) provide efficient methods for cash repatriation; iii) allow flexibility on exit; iv) retain flexibility for acquisition financing; v) minimise tax leakages; and vi) have the ultimate control of the structure.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

The structuring of the equity depends on various factors such as the acquisition structure, the Target group, the seniority and role of the management, etc.

In a scenario of a non-Italian private equity firm and of a non-Italian (EU) Topco, the share capital of the Italian Bidco generally consists of ordinary shares while the equity of the EU Topco may be composed of ordinary, preference and performance shares. The management typically i) subscribes for the so called "sweet equity" at the level of Topco, or ii) subscribes for financial instruments (i.e. warrants) issued by the Italian Bidco.

In case of Italian private equity funds structures, the management commonly invest *pari passu* to the Italian fund in ordinary shares of the Italian Topco. The managers' shares usually have restricted administrative rights.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

The minority position will mainly impact the structure of the governance. In such a scenario, the private equity usually get a veto right on the strategic decisions and request the right to appoint of one or more directors.

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2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Management typically invests less than 10% of the equity.

In case of investment in the non-resident Topco (typically a Luxco), managers invest in preferred or performance shares whose returns are linked to the return (i.e. MoM/IRR) of the sponsors in the event of exit (trade sale or IPO).

Moreover, the shareholders' agreements usually include tag-/drag-along provisions.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

The leaver ship provisions, if any, may be structured in many forms. The most frequent definition of bad leaver includes any case where the employment relationship with the manager is terminated by the company with cause (*giusta causa*).

Good leaver definitions generally include any event in which the employment relationship with the manager is terminated without cause (*giusta causa*) or a manager retires over statutory retirement age or in case of long-term illness.

The presence of leaver ship clauses may impact on the tax qualification of the gain realised by the managers.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

Private equity and minority co-investors typically enter into a shareholders' agreement to govern their relations and the management of the Target group.

The shareholders' agreements may include the right to appoint the majority of the directors and therefore control the Target decisions and/or veto rights (especially in case of minority private equity investors) on certain strategic decisions or business and financial matters.

The shareholders' agreements are confidential (the company's by-laws are public).

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Private equity generally has the right to appoint the majority of board members of the Holdcos and portfolio companies and therefore control the relevant decisions.

In case of minority stake, they generally have veto on certain strategic decisions or business and financial matters and may also negotiate a set of business-related protections/related matters.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

There are no specific rules which limit the effectiveness of the veto arrangements. It is worth noting that the shareholders' agreements are based on contractual provisions as set out in the agreements. Therefore, veto rights are relevant between the parties but not *vis-à-vis* third parties.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

This is not usually the case. Call and put options provisions are commonly used.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Under the Italian law, shareholder agreements can have a duration of no longer than five years and no automatic renewal is allowed. Non-compete and non-solicit provisions are commonly included in the agreements but they have to be drafted properly as an over-excessive provision can make the entire provision invalid.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

There are four fundamental directors' duties, which must always be complied with by directors in the rendering of their services, and namely they:

(i) must act in accordance with any applicable law and the company's by-laws;

(ii) must act with the diligence required by the services to be performed and based on their respective specific skills and knowledge;

(iii) must act in an informed manner; and

(iv) must not act in conflict of interests with the company.

The diligence required to each director is directly connected with the director's specific role as an executive or a non-executive director. Because of the above, a non-executive director is mainly required (to be informed and) to supervise the company's management by the executive director(s), through an internal auditing system.

Based on the above, with respect to the directors' liability towards the company, the Italian Civil Code, provides that:

(i) the directors are jointly and severally liable towards the company for any damage caused by the breach of their duties, unless the violation is related to specific duties delegated to one or more directors or to a committee; and

(ii) a non-executive director is, however, jointly and severally liable in case of damages arisen from fact/acts/omissions/

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circumstances which were known by him/her, to the extent that he/she has not done his/her best in order to prevent, eliminate or limit such damages.

The Italian Civil Code sets forth three different kinds of civil liability of the directors: (i) liability towards the company; (ii) liability towards the company's creditors; and (iii) liability towards the company's individual shareholders *uti singuli* or third parties.

Moreover, specific liabilities are provided for in special laws (e.g. labour, taxation, environmental and bankruptcy laws).

The Italian Civil Code sets forth two general conditions to be satisfied before a director may become liable for his/her acts or omissions: (i) he/she must have breached his/her duties; and (ii) the breach has caused damages to the person who is bringing the action.

Directors nominated by the private equity generally have no executive roles within the board.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Duties of the directors are owed to the company and not to the party nominating them.

Where a conflict exists, directors are required to declare their interest in the transaction that the board of directors of the company is going to approve.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

The timeline of the transactions is impacted by regulatory approval (mainly competition and sector-specific approval), the negotiation of the financing commitments, the board of directors and shareholders' approvals, the due diligence activity and any specific conditions precedent included in the SPA. As the Italian transactions generally involve mid-market acquisitions, the antitrust authorisation process is not required.

4.2 Have there been any discernible trends in transaction terms over recent years?

The M&A landscape has been favourably affected by the clarifications issued by the Italian Tax Authorities in 2016 on the MLBO transactions and related debt pushdown (please refer to question 9.4).

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

In public-to-private transactions specific domestic rules apply (Law Decree no. 58/1998 – TUF).

The acquisition process involves a tender offer. This implies significant disclosure obligations, the imposition of a strict timeline and the approval by the competent authorities. In addition, the high level of confidentiality around listed companies creates difficulties in the due diligence process. The acquisition of the entire share capital is also a challenge as the squeeze-out can only be realised if the offering party achieve a 95% shareholding.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

There are no specific rules.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

On the seller's side, private equity investors prefer to offer very limited warranties.

On the buy-side, they generally need to obtain a strong set of guarantees.

The "locked-box" structure is fairly common in the Italian private equity deals, in particular in case of private equity sellers. This structure is preferred by the private equity as it offers control over the financial information and reduces the contractual liabilities. The seller undertakes not to extract value in the period between the locked-box date to the closing of the transaction.

In addition, on the buy-side, private equity investors generally prefer the one-to-one transaction (rather than a competitive auction).

In case of minority investment, a way out after a certain period of time is commonly agreed.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

It depends on a case-by-case basis. As anticipated, the package of warranties/indemnities offered by a private equity seller is generally very limited.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

The standard set of the undertakings consists of no-leakage covenants and guarantees.

Liabilities under any no leakage covenant are generally capped to a specific amount and have a timely limit.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

The use of insurance is very limited in Italy due to the high costs and the required very detailed DD exercise.

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6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Sellers' warranties are generally limited to title, capacity and authority and are limited to a relatively short period of time after closing.

Private equity sellers' warranties are also typically subject to a cap limitation equal to the aggregate purchase price. In addition, *de minimis* and thresholds/baskets are also negotiated to further reduce the exposure.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Private equity sellers do not generally provide securities as they only provide very limited warranties and also because they have to return to their investors the exit proceeds in a short period of time post-closing.

Private equity buyers commonly ask for escrow amounts or other securities (i.e. bank guarantee) to secure the liabilities, especially if the sellers are individuals. As an alternative the price is structured with a component of deferred consideration or earn-out which is reduced by the liabilities.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Private equity sponsors usually provide the seller with an equity commitment letter attesting that it will call the required capital from the investors and that said capital will be injected in Bidco for the purpose of the acquisition of Target.

With regard to the bank financing, a debt commitment letter is also shown to the seller to give comfort on the availability of the financial means.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

They are not commonly used in the Italian market.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

The exit through an IPO is generally used for large-size deals.

The main features which have to be considered in an IPO scenario are: i) the market conditions which might affect the pricing and the timing of the transaction, ii) the lock up agreements which prohibit to the private equity a fully exit for a certain period of time, iii) the new corporate governance which generally reduces the private equity rights, and iv) the costs which are materially higher compared to a trade sale scenario.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

The sponsors' lock-up periods are defined on a case-by-case basis. Typically, it is imposed for period between six and 12 months.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Dual-track processes are not uncommon in the Italian market. However, most of the exits occur via trade sale.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Private equity acquisitions are generally financed by senior bank loans provided by a pool of banks.

In larger transactions, the acquisitions are frequently financed by bonds/notes, generally listed on EU regulated markets/multilateral platforms and issued by Bidco.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

Financial assistance is not permitted under the Italian law. Therefore, the Target company cannot give assistance with regard to the purchase of its own shares.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

The access to the debt financing market should continue to be relatively easy for private equity.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Non-Italian private equity funds generally invest in Italy through an EU holding structure. The EU holding platform incorporates the Italian Bidco that performs the acquisition of Target.

The key tax objectives which are considered in the structuring are: i) deduction of interest expenses on the acquisition financing

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(deduction is available within a 30% EBITDA threshold); ii) minimisation of the withholding taxes on the service of the debt and cash extraction; and iii) tax-efficient exit.

The interest deduction can be obtained with the merger of the Italian Bidco with Target or with the election of the tax unity between the Italian Bidco and the Italian Target group companies.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Capital gain realised with the sale of shares or financial instruments is taxable at a 26% flat rate while employment incomes are taxable at the individual progressive corporate income tax rate (generally 43%).

Managers which invest in the holding structure (at Italian Bidco or EU Holdco level) subscribing shares (ordinary/preference/ performance) or financial instruments (e.g. warrants) at fair market value are, under certain circumstances, considered as pure co-investors and the relevant gain taxable at 26% CGT.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

Both the sale and the roll-over of the investment are treated as taxable event for Italian individuals.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

- LBO transactions have been challenged by the Italian Tax Authorities for several years. On March 2016, the Italian Tax Authorities issued important guidelines on MLBO/LBO transactions and clarified that the Italian acquisition vehicles are allowed to deduct interest expenses incurred in the context of the acquisition of Target (within the 30% EBITDA threshold). The guidelines contain clarifications also on the cross-border structures with a particular focus on the IBLOR structures, on the withholding tax treatments of the cross-border flows and on the capital gain tax. Said clarifications are, in particular, focused on the beneficial ownership and on the substance of the holding structures.
- Specific rules on the carried interest were introduced in 2017 (art. 60 Law Decree 50/2017). Under certain conditions, the gains arising from the disposal of financial instruments/ shares bearing a carried interest, which are held by the management, are qualified as capital gain (taxable 26%).

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

EU Member States are subject to the AIMFD regulations. With regards to private equity transactions, AIMFD rules provide a number of requirements in terms of disclosure and restrictions on the ability to release assets from portfolio companies.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

The regulatory scrutiny regards particular sectors such as banks and insurance where the private equity does not frequently invest.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

A detailed legal, tax, financial, commercial and environmental due diligence is conducted by third-party advisors before an acquisition. The materiality is determined based on the size and business of the Target.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Anti-bribery and anti-corruption legislation impacted all the transactions without any specific difference for private equity deals.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

As the portfolio companies are generally incorporated as limited liability entities, the liabilities of the shareholders are limited to the equity contributed. One company is liable only for its own actions.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Most of the relevant factors have been addressed in the foregoing.

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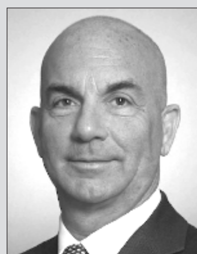

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The Firm has grown steadily over the years and has continually sought to reinforce its multi-disciplinary approach by creating specialised centres of excellence.

The Firm's services cover tax matters such as domestic and international tax compliance and planning, transfer pricing, VAT and tax advisory to expatriates, as well as legal matters in respect of M&A, private equity transactions, banking and financial matters, including regulatory aspects, corporate and commercial law, aviation, labour law, IT law and copyright and litigation. The Firm also provides corporate finance services.

The Firm has 10 offices in Italy, one in London, one in Beijing and one in Shanghai. It acts independently with more than 350 tax consultants and 150 lawyers as well as with world-wide correspondents.

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Luxembourg

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

Luxembourg is one of the most pre-eminent jurisdictions globally for the structuring of private equity transactions, both in the regulated and the unregulated space. Luxembourg has developed an impressive toolbox of structuring solutions to accommodate investments in both spaces. Besides the "all time classic", the non-regulated SOPARFI (participation holding companies in any form available for commercial companies under the Luxembourg law of 10 August 1915 on commercial companies (1915 Law)), the most significant examples are the creation of the SICAR in 2004 (regulated investment company in risk capital), the SIF in 2007 (specialised investment fund, a regulated alternative investment fund (AIF) vehicle used for any type of investment, including private equity) or the RAIF (reserved alternative investment fund, not subject to supervision by the Luxembourg financial supervisory authority (CSSF), but to be managed by an authorised external alternative investment fund manager (AIFM) within the meaning of the AIFMD). On the unregulated side, recent years have seen an increasing use of the overhauled S.C.S. and the new S.C.Sp. type of partnerships (LP), the latter created in 2013 as a flexible structure without its own legal personality similar to an English LP to accommodate investors from an Anglo-Saxon background.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Luxembourg has been a major hub in the private equity industry for over 20 years and continues to attract an increasing number of private equity firms. Luxembourg has positioned itself as one of the jurisdictions likely to benefit from Brexit by attracting private equity houses and asset managers thanks to its distinctively private equity-friendly environment. The following factors are typically mentioned as encouraging private equity transactions in Luxembourg: political and economic stability; an attractive tax framework with a large number of double tax treaties; the modern and pragmatic legal framework with a wide array of available structures; a multilingual and technically-skilled workforce; and finally the strong governmental commitment towards the private equity sector.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

PE funds structured under the RAIF regime or as unregulated LPs have increased by almost 20% in 2018 and it is expected that this trend continues in the next 12 months. Luxembourg will continue to attract PE funds from all over the world and it is likely that the country will continue to follow the current growth path (in 2018, pursuant to a recent ALFI survey, assets under management across 640 private equity funds regulated in the country reached €88.5 billion, up from €73.8 billion for nearly 630 funds in the previous year).

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Acquisition structures typically include one or more Luxembourg unregulated SOPARFI companies which in turn acquire and hold the target shares or assets. In secondary buy-out situations, typically the original acquisition structure is sold as part of the transaction. In recent years, LP structures have become a preferred choice of structuring investments in private equity transactions. LPs can be unregulated SOPARFIs or established as one of the (directly or indirectly) regulated types (SICAR, SIF or RAIF). In both alternatives, the LP regime benefits from a large degree of flexibility. Unregulated LPs are often used for feeder funds, carried interest vehicles or "club deal" type of co-investment constellations.

2.2 What are the main drivers for these acquisition structures?

Acquisition structures typically include one or more Luxembourg unregulated SOPARFI companies which in turn acquire and hold the target shares or assets. In secondary buy-out situations, typically the original acquisition structure is sold as part of the transaction. In recent years, LP structures have become a preferred choice of structuring investments in private equity transactions. LPs can be unregulated SOPARFIs or established as one of the (directly or

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indirectly) regulated types (SICAR, SIF or RAIF). In both alternatives, the LP regime benefits from a large degree of flexibility. Unregulated LPs are often used for feeder funds, carried interest vehicles or the "club deal" type of co-investment constellations.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

Acquisition structures typically include one or more Luxembourg unregulated SOPARFI companies which in turn acquire and hold the target shares or assets. In secondary buy-out situations, typically the original acquisition structure is sold as part of the transaction. In recent years LP structures have become a preferred choice of structuring investments in private equity transactions. LPs can be unregulated SOPARFIs or established as one of the (directly or indirectly) regulated types (SICAR, SIF or RAIF). In both alternatives, the LP regime benefits from a large degree of flexibility. Unregulated LPs are often used for feeder funds, carried interest vehicles or the "club deal" type of co-investment constellations.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

A minority private equity investor will typically aim to mitigate the lack of control by other mechanisms protecting it against the majority investor, e.g. veto rights in major decisions, anti-dilution provisions, share transfer restrictions, exit provisions, etc. These provisions are usually included in shareholders' agreements or LP agreements.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Management equity will typically represent a small percentage of the equity and management equity holders will undertake either not to vote or to vote as the sponsor directs. The typical vesting and compulsory provisions are similar to what can be seen in other European jurisdictions, and transaction documents usually include (good leaver/bad leaver) provisions allowing the private equity sponsor to acquire management's equity upon termination of the manager's employment with the relevant portfolio company. The management's exit upon exit of the sponsor is typically ensured by drag-along provisions, combined with share pledges or call options in the sponsor's favour. Alternatively, management equity is structured in a separate vehicle investing alongside the main acquisition vehicle, often in the form of an LP managed by the sponsor.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

A management equity holder would typically be considered a good leaver if leaving for reasons of permanent incapacity or illness or death and, in some instances if dismissed without cause. A management equity holder dismissed for cause of resigning voluntarily would be considered a bad leaver.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

Governance arrangements such as the right to appoint nominee directors, restrictions of transfer of shares, tag-along and drag-along rights, pre-emption rights, matters requiring shareholder consent, distribution of proceeds and exit provisions are typically part of shareholder agreements or LP agreements. Neither agreement is required to be made public, but as a way of easing enforcement it is common to reflect certain key provisions, e.g. those governing transfer of shares, in the articles of association of the company which are public in order to make the provisions of the shareholders' agreements enforceable against third parties.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

It is common to provide for veto rights for private equity investors in shareholders' agreements over major corporate actions. The scope of the veto rights will, to a large extent, depend on the overall influence, i.e. the share percentage held, with minority investors typically enjoying veto rights only over fundamental actions and less over business planning and strategy matters.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

Veto arrangements both at shareholder level and at board level are generally effective as an expression of the prevailing principle of freedom of contract as long as they are not contrary to public policy rules in Luxembourg (e.g. by depriving a shareholder entirely of its voting rights or by completely excluding a director from board deliberations). Voting arrangements typically address these limitations by including the appropriate exceptions.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

Private equity investors do not have any specific fiduciary duties toward the minority shareholders. As a general rule, however, a majority shareholder shall, at all times, refrain from abusing its majority rights by favouring its own interests against the corporate interest of the company. Luxembourg law also clearly distinguishes between interests of the shareholder(s) and interest of the company; a director, albeit a nominee of a shareholder, needs to act in the company's interest, not in that of the nominating shareholder.

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3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

As an expression of the overarching principle of freedom of contract, the parties may agree what they commercially deem appropriate, with certain restrictions applying under Luxembourg public policy rules, e.g. clauses excluding the risk of loss for one party or the right to a share in the profits for another party would be ineffective. The parties are generally free to choose the governing law and jurisdiction. Historically, English or New York law and courts have been the preferred choice; however, more recently there has been a clear shift to using Luxembourg law and courts or arbitration. Non-compete and non-solicit provisions are common and not subject to specific restrictions (assuming that none of the shareholders is at the same time an employee of the company).

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

A director nominated by a shareholder does not owe any particular duty to that shareholder. To the contrary, the directors of a Luxembourg company have the duty to fulfil their mandate in good faith and to carry out their duties in the best corporate interest of the company itself which is not necessarily in line with, or even contrary to, the interest of the private equity investor. Moreover, the directors are bound by confidentiality duties and cannot easily disclose sensitive and confidential information related to the business of the company to the shareholders. This somewhat delicate position may in practice expose nominee directors to increased liability risks; generally, their obligations do not differ from those of any other director. Private equity investors are generally not liable for the acts and omissions of their nominee directors, as long as they do not interfere directly with the company's management, in which case they may be held liable as *de facto* directors.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Under Luxembourg corporate law, a director who has, directly or indirectly, a monetary interest which is opposed to the company's interest is under the obligation to notify the existence of such conflict of interest to the board of directors, have it recorded in the minutes of the board meeting and refrain from participating in the deliberation with respect to the transaction in which the impacted director has a conflicting interest. Finally, the next general meeting of shareholders must be informed by the board of directors of the existence of such conflicts of interest. The fact that a nominee director is, at the same time, director of another portfolio company does not create a conflict *per se*, but the director needs to be mindful that the notion of group interest is applied very restrictively in Luxembourg and as a general principle only the interest of the individual company itself is relevant.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

Private equity transactions in Luxembourg do not usually require any antitrust or regulatory clearances in Luxembourg itself. However, if the transaction concerns a target in a regulated sector such as the financial sector, the approval of the regulatory authorities such as the *Commission de Surveillance du Secteur Financier* (CSSF) will be required. Such approval requirements may also apply to the funding of the acquisitions of a regulated business.

4.2 Have there been any discernible trends in transaction terms over recent years?

The modernisation of the 1915 Law and the constant thriving of the Luxembourg legislator to expand the "toolbox" of available structuring alternatives (including the transposition of Anglo-Saxon style instruments into local law such as the new LP), coupled with the wealth of experience and understanding by courts and other authorities for the particularities of the private equity industry, have led to an increasing readiness by private equity investors to submit the transaction documents to Luxembourg law as the governing law, while historically English law or New York law would have been the preferred choice. To a certain extent this tendency also applies to the choice of Luxembourg as the place of jurisdiction (often coupled, however, with the submission to an arbitral tribunal instead of state courts), with the arbitration procedure being held in Luxembourg.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Due to the very small number of Luxembourg companies publicly listed in Luxembourg itself that may be potential targets of private-to-public transactions, it is difficult to identify a genuine market standard for this type of transaction. From a strictly legal perspective, such transactions are subject to the Luxembourg securities law, the takeover law implementing the EU Takeover Directive and the squeeze-out law provision imposing specific restrictions, a stringent procedural framework and a strict timetable.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

As a general principle in Luxembourg law, the parties have contractual freedom to negotiate and to abort the negotiations at any point during the process unless the negotiation is so advanced that one party can legitimately expect from the counterparty that the deal is about to be done.

That said, it is possible for the parties to contractually provide for specific deal protections, such as break-up fees provided that the amount of the break-up is proportionate to the size of the deal.

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6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

The vast majority of private equity M&A transactions realised in Luxembourg have a cash-for-shares type of consideration. Arrangements including shares-for-shares types of consideration or merger arrangements are possible, but fairly rare. A sell-side private equity investor will naturally prefer a full payment of the cash consideration at closing, while a buy-side private equity investor will attempt to retain a portion of the purchase price as collateral for potential warranty/indemnity claims. Earn-out components are also seen but less frequent than in other jurisdictions.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

The package of warranties/indemnities is similar to the ones typically given by a private equity seller in other European jurisdictions, i.e. a private equity seller will usually provide warranties only with respect to title, capacity and authority and certain tax matters. A private equity seller will typically resist against giving any operational or business warranties. Management teams may be pressured to give operational warranties if they co-sell their shares alongside the private equity seller.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Similar considerations as in other jurisdictions apply to covenants regarding the conduct of business in the period between signing and closing and would depend on the nature of the business, the length of the pre-closing period and on whether the management team will be taken over by the buyer. Non-leakage provisions will be found in any purchase agreements using a "black box" purchase price model. Restrictive covenants (non-compete, non-solicit) are common. Indemnities will typically be given for tax matters relating to periods pre-signing/pre-closing.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Warranty and indemnity insurances are increasingly common in Luxembourg. However, while it is too early to identify a genuine market standard for Luxembourg, the likely providers of W&I insurances are the same players as in other European jurisdictions and it may be expected that similar limitations, carve-outs and exclusions will become market practice standards as in other European jurisdictions, but this is always subject to negotiation. The premium for W&I insurances for Luxembourg acquisition agreements typically ranges from 0.9% to 1.8% of the insured sum.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

The limitations are similar to the ones applied in other European jurisdictions, i.e. general limitations include time limits within which the claims can be brought (typically between 12 and 24 months) and limitation of financial exposure to a capped amount. With respect to the latter, depending on the bargaining position of the seller, caps of 30% up to 100% of the purchase price can be observed. Indemnities for particular risks identified in the due diligence exercise may, in very exceptional cases, be uncapped.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Private equity sellers will generally resist providing security for any warranties/liabilities due to their interest to distribute proceeds to their sponsors. Escrow arrangements for a (small) proportion of the purchase price are seen occasionally, but private equity sellers will rather tend to resolve warranty matters as part of purchase price discussions. Management teams, if at all liable for warranty or indemnity claims, will typically not be asked to provide personal security (other than possibly the vesting of shares in the target if the management team is taken over and a management incentive programme is put in place at the target).

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Equity commitment letters by the private equity fund to the SPV's benefit are a frequent means for private equity buyers to provide financial comfort. Less frequently, the private equity fund itself or an affiliate with proven financial wealth may become party to the transaction documents as a guarantor for the SPV. In either alternative, the liability is limited to contractual damages and no specific performance of the SPV's obligations may be claimed.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees have not (yet) been observed as a standard practice in the Luxembourg market.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

IPO exits are not frequently seen in Luxembourg as there are very few publicly listed companies in Luxembourg that would be eligible. However, the legal and regulatory framework exists and an

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IPO initiated by a private equity seller would be carried out under supervision of the CSSF and subject to the provisions of the Luxembourg prospectus law.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

A lock-up period of up to 180 days seems to be a standard period in an IPO exit in Luxembourg.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Dual-track exits combined with an IPO in Luxembourg are not common in Luxembourg due to the reasons set out above. As the overall number of dual-track exits involving Luxembourg entities is very small and the possible timeframe for continuing the dual track depends largely on the procedural requirements of the IPO pursued in another jurisdiction, a common standard cannot be identified at this time.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Traditional bank-led leveraged loan financing remains the most common source of debt finance used. Bank financing is typically sourced from outside of Luxembourg with UK and German banks and, to a lesser extent, US and French banks being amongst the most frequent lenders.

High-yield bonds which are usually listed on the Luxembourg Stock Exchange are another frequent source of financing.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

There are no particular legal requirements or restrictions that would affect the nature or structure of the debt financing. There is no specific legislation regarding thin capitalisation, but generally a debt-to-equity ratio of 85:15 is accepted by the tax authorities in Luxembourg. From a corporate law perspective, however, in dealing with debt financing the corporate interest of the borrowing or guaranteeing company needs to be taken into account and special attention should be given to the rather restrictive rules governing financial assistance and upstream or cross-stream guarantees.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

Luxembourg, through the law of 5 August 2005 on collateral arrangements, offers a legal framework that is likely the most lender-friendly in any European jurisdiction and international lenders increasingly opt to use Luxembourg as a convenient jurisdiction to secure the financing, irrespective of the governing law of the loan documents and irrespective of the location of the underlying assets.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

The tax framework in Luxembourg is considered among the most stable and business-friendly in Europe for companies, their shareholders and their employees alike. Luxembourg is not, and does not aim to be, a tax haven, but it offers one of the most flexible and attractive tax regimes within the EU. Luxembourg has bilateral tax treaties with all EU Member States (except Cyprus) and with a number of other countries (including almost all OECD Member States).

SOPARFIs (other than LPs) are subject to normal corporate taxation but benefit from Luxembourg's extensive network of double-taxation treaties and from the EU Parent-Subsidiary Directive. Despite it being fully taxable, various structuring alternatives are available for SOPARFIs allowing for the exemption of many income and exit tax charges for private equity investments.

SICARs (other than LPs) are subject to normal corporate taxation, but income derived from securities held by a SICAR does not constitute taxable income. Capital gains realised by non-resident shareholders are not subject to tax in Luxembourg. Dividend and interest payments are exempt from withholding tax.

LPs are tax-transparent and not subject to corporate income tax.

SIFs, irrespective of the legal form, are not subject to taxes on capital gain or income in Luxembourg. The only tax due is a subscription tax of 0.01% based on the quarterly net asset value of the SIF.

RAIFs are subject to the same tax regime as SIFs, but can opt for the SICAR regime if the RAIF invests in risk capital.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Carried interest: management teams employed by an AIFM may have income derived from carried interest taxed at 25% of the global tax rate, if certain conditions are fulfilled, e.g. the recipient becoming Luxembourg tax resident, no advance payments having been received by the recipient and the carried interest being conditional upon the prior return to the equity investors of their initial investments.

For Luxembourg resident managers it may be tax-efficient to structure the receipt of carried interest as sale of shares or securities issued by the AIF, in which case the exemptions described in questions 9.1 and 9.3 below will apply.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

Capital gains realised by non-Luxembourg resident managers on shares issued by a Luxembourg company are only taxable in

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Luxembourg if the capital gains are realised upon the disposal of a substantial participation (more than 10% over the five years prior to the date of the disposal) within six months from the acquisition of the shareholding; Luxembourg resident managers may benefit from similar exemptions and may further benefit from the exemptions described in question 9.1 above.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

By the law of 18 December 2015 transposing the Council Directive (EU) 2014/107 of 9 December 2014, itself implementing the Common Reporting Standard developed by the OECD as part of the BEPS action plans at European Union level, the Luxembourg legislator has imposed on Luxembourg financial institutions (including in certain cases SOPARFIs, SICARs, SIFs and RAIFs) the obligation to (i) collect certain information about their sponsors that are fiscally resident in a EU Member State or in a country with a tax information sharing agreement with Luxembourg, and (ii) report such information to the Luxembourg tax authorities, thus facilitating an automatic information exchange between the participating tax authorities on an annual basis.

The Council Directive (EU) 2016/1164 of 12 July 2016, setting forth rules against tax avoidance practices directly affecting the functioning of the internal market (ATAD), has been transposed into domestic law in Luxembourg by the adoption of the ATAD law of 21 December 2018, comprising certain additional measures not contained in the ATAD.

Finally the multilateral instrument (MLI) signed on 7 June 2017 by 68 jurisdictions, including Luxembourg, in view of aligning existing tax treaties with the different BEPS action plans, will have a significant impact in Luxembourg resulting from article 5 of the MLI, under which Luxembourg has opted for a solution, whereby Luxembourg must apply the credit method on dividends received by a Luxembourg company from a foreign company, instead of the exemption method, which is currently the standard method for Luxembourg double tax treaties.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

There are no specific laws or regulations applicable to the private equity investors. In structuring their deals, the private equity investors must comply with the provisions applicable in the context of corporate transactions, e.g. company law in Luxembourg, anti-money laundering laws, and the Alternative Investment Fund Manager Directive.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

Private equity transactions are not subject to any particular restrictions; as a large part of the transactional activity in Luxembourg consists of the involvement of Luxembourg structures ultimately holding assets in other jurisdictions, specific or regulatory scrutiny often originates from such other jurisdictions.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

Similar to other European jurisdictions, private equity investors typically conduct a relatively detailed legal due diligence. The timeframe depends on the complexity and the number of documents to be covered within the scope of the due diligence. The due diligence process is usually conducted by outside legal and tax advisors alongside the auditors conducting the financial due diligence. If the focus in Luxembourg is on the holding structure, this necessarily impacts the scope of the due diligence, i.e. due diligence will typically be limited to title, corporate governance and financing arrangements.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Luxembourg scored 82 points out of 100 on the 2017 Corruption Perceptions Index reported by the NGO Transparency International, making it one of the least corrupt countries in the world. Anti-corruption legislation has been strong for decades and transparency has been fostered by a number of reforms over the years. In that respect, it is worth noting that Luxembourg has now largely implemented the 4th AML Directive. A private equity investor shall, throughout the life cycle of an investment in Luxembourg, comply with applicable anti-money laundering legislation. While sometimes burdensome for an investor in the context of a fast-moving transaction, the stringent AML legislation has contributed to Luxembourg's reputation as a transparent and trustworthy jurisdiction for transactions of any scale.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

As a general principle it is not possible for a third party to pierce the corporate veil, i.e. the liability of the private equity investors in their capacity as shareholders or limited partners of private/public limited liability companies or partnerships is limited to their contribution to the share capital of the company. However, in case of partnerships, if a private equity investor in its capacity as limited partner gets involved in the active management of the partnership, its liability can be sought beyond the amount of its share capital contribution. Similarly, a shareholder of a private/public limited liability company becoming personally involved in the management of the company and committing management faults, may be held liable as a *de facto* manager.

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11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Luxembourg has created an environment and legal framework showing a clear commitment to promote the private equity sector. Private equity firms should not face any particular issues or concerns apart from the ones indicated specifically in this chapter.

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Holger's experience includes advising:

- NYSE-listed WestRock Company, on the German and Luxembourg aspects of the $1.025 billion disposal of its home, health and beauty division to Silgan Holdings Inc. and the acquisition by WestRock of Multi Packaging Solutions International Limited.
- The Teacher Retirement System of Texas on the acquisition of KBC Bank Deutschland, the German banking business of Belgium's KBC Bank (today Bremer Kreditbank) and the acquisition of Oldenburgische Landesbank by Bremer Kreditbank.
- A leading New York private equity house on the structuring and financing in relation to several investments in Europe, including the acquisition of the Spanish manufacturer of food cans Mivisa Envases and the investment in the largest German off-shore wind farm.
- The private equity investors in the sale of Nycomed Group by the Luxembourg holding entity Nycomed SICAR and the subsequent exit from the SICAR.

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José holds a postgraduate degree (*Mastère Spécialisé*) in international business law and management from the École des Hautes Études Commerciales (HEC), Paris (France) in partnership with the École Supérieure de Commerce de Paris (ESCP) (France), and a Master's degree in foreign affairs from the Universidad Complutense, Madrid (Spain) in partnership with the Spanish School of Diplomacy, Madrid (Spain).

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Our corporate lawyers are well versed advising across the full spectrum of corporate transactions for leading global and national businesses. Our team in Luxembourg is particularly experienced in advising companies and institutions on complex multijurisdictional transactions.

Our Investment Funds team is experienced in advising clients on the structuring, formation and management of investment funds, corporate transactions and regulatory or compliance matters. As part of the Eversheds Sutherland global network, we hold an excellent understanding of local Luxembourg law within a wider commercial context.

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Macedonia

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

As in most jurisdictions, the types of equity transactions in the Republic of North Macedonia come in various forms such as capital transactions, private and public M&A, financial instruments buyout, swaps, real estate, etc.

The general trend is a slow but steady increase of investments. However, the mechanisms used for investing and transferring private equity (PE) remain fairly traditional due to the conservative nature of the local market, its small size and the fact that modern financial and corporate trends have not penetrated the business or law community. As a result, most equity transactions are conducted with simple and regular agreements and one can rarely see complex vehicles used for making PE transactions.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

One significant factor encouraging PE transactions is the fact that the Republic of North Macedonia has a fairly simple, fast and efficient administrative environment for doing business. Namely, conducting equity transactions is efficient and accompanied with relatively low administrative costs. The corporate taxation system offers a flat rate tax of 10%. Also, the legal treatment of foreign investors is almost equal to residents in every field, including the acquisition of real estate.

An inhibiting factor is the fact that the economy is small and not very integrated in global trade chains. Another factor is the restrained nature of debt financing. Until recently, political instability might have discouraged investments, especially of small- and middle-sized companies or investment funds. As a result, there is a limit to the frequency of equity transactions especially more complex ones.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

Every consecutive government in the past has invested energy in attracting foreign investors in the state, by offering competitive tax rates and by presenting the benefits of investing in the state around the globe. This policy has contributed to significant inflow of capital, know-how and the pace of development, domestic consumption and investment; it is likely to continue. In addition, the government has initiated an ambitious start up support programme that might lead to inventive concepts that will attract the interest of PE investors, who are looking for placement of their capital.

Thanks to the final resolution of the so-called "Name Disputed", the next 12 months, and in the long-term, we are likely to see the pace of these positive trends pick up, as the Republic of North Macedonia enters NATO and opens the EU negotiation process. One most obvious indication is the increased trading rates and index prices of the Macedonian Stock Exchange.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Investors usually purchase shares in local companies either directly or through an investment vehicle located in a jurisdiction that has a stable and flexible corporate regime, but also has a double taxation avoidance agreement with the Republic of North Macedonia. This structure is especially used when there is more than one investor in the investee company, whereby all the investors acquire shares in the investment vehicle company, which in turn wholly owns the investee company.

The foreign PE transactions are usually supported by syndicated bank loans or holding corporate capital, secured by guarantees and other security instruments.

2.2 What are the main drivers for these acquisition structures?

There are few types of reasons why such structures are preferred. One driver is the fact that the local corporate law regulation is a bit rigid and investors would like to have more freedom in potential sales, pledges or other activities involving the shares. Another is the fact that foreign investors do not trust that the local courts would have the competence or the impartiality to solve any potential shareholder disputes.

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2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

There is no legal regulation of these matters and most of them are left to the contractual freedom of the shareholders to structure the articles of association as it suits them best.

When PE investors invest in an already existing company and do not want to get involved in the management of the company, they retain the management. If the management prior to the acquisition owned the company, the management usually retains a certain amount of shares (minority) and in some cases a guaranteed place in the management or supervisory boards.

Though carried interests are not regulated in any way, there is no limitation to regulate the relations with the articles of association or a separate contract.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

An investor would seek to acquire at least 10% of the investee shares due to the fact that this amount of holdings is the threshold for acquiring certain control and blocking rights deriving from the Law on Trade Companies. Investors would also seek to have the articles of association amended in a way that gives them a position of a member of the supervisory or executive board.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

The range of equity allocated to management usually vary between 5% and 20%. Vesting periods are rare and therefore it is not possible to state what the typical timeframe would be.

In regards to compulsory acquisitions, provisions may be in the form of exclusion of the manager-equity holder. The way this is to be done is left up to the freedom and creativity of the shareholders. In such a case the articles of association must stipulate the conditions, procedure and consequences of the exclusion, i.e. compulsory acquisition.

Note that, if the manager refuses to voluntarily accept a compulsory acquisition, the matter must be resolved by the courts and therefore any compulsory acquisition would be blocked or postponed.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Practice for good/bad leaver situations are non-existent in the local practice.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

One EP company is usually governed by the articles of association and internal regulation documents, such as decisions of shareholders and management/supervisory bodies. These prescribe rights to fill management/supervisory positions, rules and procedures for selling shares, grounds for exclusion and reporting rights. Managerial agreements might regulate specific rights, duties and incentives of managers. Of the enumerated documents only the articles of association are publicly accessible to anybody through an excerpt from the Trade Registry.

Governance arrangement can be made with inter-shareholder agreements, without including such arrangement in the corporate documents of the company. However, these would have effect for only the involved shareholders and not any third parties.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Minority investors and their director nominees enjoy veto rights for major corporate decisions such as related party transactions, changing of the articles of association, liquidation of the company, deals that take up a significant amount of share capital and other particular situations, on the basis of the law itself. For this veto right to exist under statutory provisions, the minority shareholder should have a certain amount of share capital or decision-making rights.

However, the veto rights can also be regulated by various corporate acts, whereby the articles of association hold the primacy. In terms of shareholder decisions, the necessary majorities and situations for their usage can be listed. Certainly, veto rights of some investors can also be explicitly stated. In addition, one can also regulate the veto rights of managers nominated by one investor.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

There are no limits to the effectiveness of any veto arrangements, neither on the shareholder's level nor the director nominee level. For the shareholder's level, the law stipulates that there are certain minimum support majorities necessary for certain decisions to be made; however, it is clearly stated that the shareholders can arrange for higher majorities for different situations if they deem appropriate. On the management level, allocation of blocking rights may be done with the articles of association or the decision for appointment of the individual's position holder.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

There are no statutory duties owed by a PE investor to minority shareholders. However, in regard to veto rights, the articles of association can allow for an arrangement between the PE investor and minority shareholders.

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3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Even though the law gives flexibility for regulating the shareholder relations and manager or supervision matters with the articles of association, the mandatory provisions of the law still limit this freedom. The same is relevant for decisions made by the shareholders. Any shareholder, management or supervisory body member, as well as any third party which has a legal interest, may submit to the court a request for a judicial reevaluation of the content of the articles of association and any other general acts or corporate decisions.

Courts of the Republic of North Macedonia have exclusive jurisdiction over the disputes arising from the establishment, termination and status changes of trade companies, which have a seat within the local jurisdiction.

Non-compete clauses are enforceable both as elements of the articles of association, but also on the basis of statutory provisions themselves. In general, they are binding during the duration of the relationship between the parties (company and management). Under the employment law, one can extend the duration of the non-compete clauses for two years after the termination of the relation for any employee.

Non-solicit provisions are generally allowed and enforceable, unless they go against some mandatory regulatory provisions, such as those deriving from competition protection law.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

All nominees for any managerial or supervisory position must fulfil the general criteria from the Law on Trade Companies. The following cannot have the quoted positions: a) founders or a members of managing or supervisory body of a company whose bank accounts have been blocked or are under bankruptcy procedure; b) persons who have a prohibition for conducting an activity, profession or duty; and c) persons convicted by a final judgment that they committed the crime of fake bankruptcy, bankruptcy with dishonest activity, and damaging or preferring creditors.

Nominees for any managerial or supervisory position in some industry branches may be required to have additional education, work experience or other qualification in order to be able to hold those positions.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

All persons holding managerial or supervisory positions must inform the managerial or supervisory organs and shareholder of any potential conflicts of interest by disclosing: (i) the ownership or control of 20% or more of the shares/voting rights in any third company; (ii) third companies in which they have a managerial or supervisory position; and (iii) all current and possible deals, in which they might be an interested party.

In addition to such information obligations, the holders of managerial or supervisory positions face prohibitions for competition, i.e. engage in the same activity themselves or are members of management or supervisory bodies in any competitor companies.

Normally, the shareholders or the managerial or supervisory bodies can approve such activities if they do not deem them detrimental to the interests of the company.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

In general, equity transactions are fairly simple and completed fast in the Republic of North Macedonia. Any extension of the timetable of the transactions will depend on the specifics of some industry or regulated business activity, such as finance, pharmaceutical, energy and similar. Thus, for some fields, prior approval is needed in order to change the ownership of the shares, while for some only a notification will suffice.

In terms of antitrust regulation there might be an obligation to notify the authorities and seek a concentration clearance if the legal geographical or profit/income criteria are fulfilled.

4.2 Have there been any discernible trends in transaction terms over recent years?

Due to the conservative and relatively isolated nature of the economy, there are no new trends that can be discerned in the last few years.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Public-to-private transactions are very rare to spot within this jurisdiction. However, there is a Law on Takeover of Joint Stock Companies, which regulates some of the relevant issues.

One thing to point out is that when one entity, alone or together with other entities with which it acts together, acquires 25% of the voting-rights-stocks, it is obliged to give an offering to buy out the rest of the stock. Note that there are some exceptions to this obligation listed in the law.

Another important point to mention is that when an offerer has acquired 95% of the voting-rights-stocks it may buy out the rest of the stocks even though the shareholders did not accept its offer.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

In cases of voluntary and mandatory takeover offers, the price is set by the offerer. However, there are mechanisms established by the

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law used for determining the minimal price of the price per stock, aimed at protecting the interests of minority shareholders. Note that the offered price must be the same for all stockholders.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

The particular type of structure PE investors prefer depends on the gap between the closing and signing, necessary approvals and business field. One option EP investors opt for, is a locked-box structure. Another option is closing adjustments, though such arrangements are rare. The parameters used for adjustment are mostly related to working capital, CAPEX and debt.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

Investors try to avoid or at least limit the warranties/indemnities when they have the capacity of a seller. Standard warranties and indemnities are simple and basic, thus covering valid title, correctness and completeness of disclosed information, as well as authority to enter the transaction or lack of any restrictions thereof. Other warranties/indemnities are very rare and are included only in big transactions.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Usually, the PE seller restricts itself to providing pre-completion guarantees such as non-disclosure of the ongoing transaction, managing the business in the regular matter and possibly the obligation to seek approval from the buyer for certain actions. Post-completion undertakings are very rare and limited.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

The insurance market is very conservative and complex insurance products for corporate representations or warranties are not present on the market. Complex and substantial investments for equity in the Republic of North Macedonia, which incorporate representations or warranties insurance, are negotiated outside of this jurisdiction.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

The limitation for a given warranties, covenants, indemnities and undertaking come in a couple of forms. Typically, limitations include: (i) exemption of claims deriving from changes of laws, regulations or administrative practices; (ii) exemption of claims based on issues of which the buyer was aware; (iii) exemption of claims on the basis of time limitations; and (iv) obligation to mitigate losses.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Security in the form of escrow accounts are present as a guarantee for the established warranties and liabilities. The degree of insistence on security of a buyer depends on the size, condition and market placement of the company, as well as the level of personal trust among the parties. For example, a listed or an established company or a transaction between established partners will be subject to less insistence on security. On the other hand, a start-up or a transaction facilitated by intermediaries or through market research would be subject to more stringent security.

In situations when one manager has strong influence and liberty in conducting the transaction, it may happen for the buyer to ask and the manager to grant security. This is usually in the form of a personal guarantee.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Though rare, banking guarantees or corporate guarantees have been offered as comfort for the availability of debt finance and equity finance. Also, sometimes personal guarantees of physical individuals in charge of the transaction can be used.

A failure of compliance could lead to payment of contractual and statutory damages, as well as returning of all acquired benefits.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees in the Republic of North Macedonia might come in the form of contractual penalty. As a result, if the buyer fails to pay the price he may withdraw from the contract but must pay the fee. Sometimes, such fees are applicable to the seller as well in case it chooses to withdraw.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

The IPO exit is only applicable to stock companies. However, other forms of companies may undergo a transformation process and become a stock company. The law allows for a limited liability company to be transformed with an IPO.

The IPOs are regulated with the Law on Securities. Issuance, offers and sales of public securities are done after a prior approval of the Commission for securities. In attachment to the request for approval the company that wishes to be listed must include a set of documents, including a prospectus.

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The IPO is deemed successful if 60% of the stocks offered by the prospectus are written down and paid for, within the public offering period which cannot be longer than 12 months.

Note that, in the whole history the Republic of North Macedonia, there have scarcely been any IPOs and most securities transfers are conducted with private offers.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

Given the fact that there has been scarcely any IPO in this jurisdiction it is impossible to say what the practice is in relation to lock-ups.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

No dual-track exit process has ever been recorded in the Republic of North Macedonia.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

The local banking sector is quite conservative in its decisions to grant credits to PE investors and would limit their financing to projects of established companies. Also, corporate debt financing – in the forms of corporate bonds or direct loans from third parties – are rare. As a result, most PE investors resort to loans of foreign banks to fund their undertakings, usually syndicated loans. In the rare case when a local bank decides to sponsor a transaction, it would most likely require a high debt-to-equity ratio.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

There are no relevant restrictions or requirements that derive from statutory obligation. The factors inhibiting debt financing derive from the business strategy nature of banks. When the debt financing is from abroad obligations for informing and reporting to the National Bank apply.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

The financing market in our jurisdiction remains conservative and no development trends are to be noted.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

The key taxation consideration is of course the 10% corporate tax rate imposed on locally incorporated or locally active companies. There is also a profit repatriation withhold tax of 10% that is payable unless there is a double taxation agreement between the jurisdictions, which stipulates something else.

The state offers tax breaks for greenfield investors, which invest in the so-called technological development zones. The typical tax break is a complete exemption to tax for a period of maximum of 10 years. However, there are caps on this break depending on the size of the investment.

Offshore structures are present in our jurisdiction; however, the new Law on the Prevention of Money Laundering and Sponsoring of Terrorism, which imposes controls of ultimate beneficiaries, might burden and inhibit the extent of these structures. In addition, it is unforeseeable what kind of impact the new "Ultimate Beneficiary Register", which was established in spring 2019 and where all ultimate beneficiaries of a company will have to be registered, will have.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Exchange of shares or other equity transaction schemes are treated as usual transfer of shares and this triggers capital gain tax obligation. No specific arrangements have been used in order to avoid this.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

There is no significant tax consideration for the management when selling or transferring shares due to the fact that, beyond capital gain of 15% tax, no other tax is imposed on such transactions.

One question that has arisen in theory recently, is whether shares or stocks awarded to a manager in the form of a managerial contracts bonus should be treated as income and thus taxed as such. If so, social contribution will have to be paid on top of the capital gains tax. While the law can be read as imposing a tax on such arrangement, in practice these ways of payments are conducted as regular share transfers and are not taxed as an income.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

There have been no significant changes in the legislation or practice of the tax authorities, aside from the increase of the tax rate from 10% to 15% for personal income tax, above MKD 1 million (*ca.* EUR 16,000) and of all income deriving from industrial property rights, income from ease and sub-lease, capital income, capital gains and gains from games of chance.

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In general, it can be said that the local authorities have a lax approach on favourable tax structures of investors as long as they are compliant with the text of the law. Namely, one of the key public policy instruments of the state for attracting foreign investors has been to keep tax levels as low as possible.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

The relevant legal framework for PE investments and transactions is given by the Law on Trade Companies and the Law on Investment Funds. However, the presence of such actors is fairly limited and therefore the practice remains underdeveloped. No significant changes in these legal instruments have been noted recently and are unlikely to change in the foreseeable future.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

The control of PE funds is conducted by the Commission for securities. However, aside from the basic prudence and responsibility checks this Commission does not pose any additional regulatory scrutiny. This is due to the extremely limited presence of EP investors, interest to facilitate investment and lack of capacities.

The background checks, approvals and guarantees applicable to all kinds of investors are also applicable to PE investors. One of the main concerns would most likely be the fact that, for some type of investment, the ultimate beneficiaries must be disclosed.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

The level of legal due diligence, which PE investors conduct prior to any acquisition varies depending on the size of the investment, the level of regulation of the field of investment and the preferences of the investors. They vary between general review of property rights, financial standing and pending court disputes or administrative fines up to detailed analyses of many aspects of corporate and regulatory activity. Most due diligences, however, are aimed at producing red-flag due issues reports.

The length of the process is usually one month long, though for major transactions this timeframe may also be longer.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Anti-bribery and anti-corruption legislation and practice for legal entities is not a major issue for PE or other investors in the Republic of North Macedonia. Therefore, it is rarely considered as a risk when entering into PE transactions. However, some investors whose corporate responsibility policy dictates so, include contractual protections to protect themselves. Investors who place due diligence on corruption are mostly motivated to do so by the extraterritorial application of the US Foreign Corruption Practice Act.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Theoretically a PE investor may be held liable for the companies in its portfolio, if these companies are of the type that does not limit liability, such as the General Partnership and Limited Partnership. However, these forms of a company are almost never used in the Republic of North Macedonia, at least by PE investors. The preferred forms are the Limited Liability Company and, more rarely, the Joint Stock Company.

Under the Limited Liability Company and Joint Stock Company, the investor is shielded from almost all of the obligations of the investee company. Under this arrangement the investor can be responsible in situations of lifting the corporate veil due to abuse of the limited liability protection in order to damage creditors.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Smaller investment might face difficulties given the fact that the market is fairly conservative and most businesses are family owned. This is why they usually choose to include a local partner in their undertaking. Bigger foreign investors face lesser hurdles due to the fact that the government or local authorities have an interest to facilitate the transaction, which might bring political and rent-seeking benefits. Both types of investors need local trusted advisors which will guide them in the market and through administrative issues, as well as protect their interest by pointing out local practices and loopholes.

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He developed his professional experience in an attorney's office in Skopje, in the Economic Chamber of Macedonia and the Republic's Council for Road and Traffic Safety.

ATTORNEYS AT LAW

Debarliev, Dameski & Kelesoska, Attorneys at Law (DDK) is the first law company established in the territory of the Republic of Macedonia, distinguishing itself in the market with a clear business and corporate law orientation, complemented by an excellent network of legal experts covering the complete territory of the Republic of Macedonia.

The quality of DDK rests mainly upon the quality of its attorneys, their accessibility and efficiency. DDK's attorneys at law share outstanding academic backgrounds, as well as a strong commitment to legal perfection.

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Mexico

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

The Mexican private equity market has been developing during recent years and the most common types of transactions in Mexico continue to be: (i) fund incorporation through vehicles such as transparent trust, investment trust (*fideicomiso de inversión en capital privado* or FICAP), Ontario or Quebec Limited Partnership (LPA) or the Mexican Corporation (SAPI); or (ii) private equity and venture capital transactions (equity, debt, and debt-like instruments).

The private equity market in Mexico is growing at a steady pace, as private equity funds operate in the country doing investments in all sectors of the economy. In the last years, private equity funds have shown great interest in the technology sector, and we foresee that private equity/venture capital transactions over this market will continue to represent a significant percentage of the private equity/venture capital investments in Mexico.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Several legal reforms that occurred during the first decade of the 21st century triggered the private equity/venture capital industry in Mexico: the creation of the (FICAP) and the transparent trust (*fideicomiso de administración no empresarial*); and the creation of the SAPI, which is a form of corporation with a very flexible regime. Further creation of new types of special purpose vehicles during the current decade, such as the real estate trust (Fibra), the capital certificate (CKD), the project finance certificates (CERPIS) or energy and infrastructure certificates (Fibra-E) have triggered investment by public pension funds (AFORES) in private equity.

On the other hand, the key factor inhibiting further expansion of the private equity industry in Mexico is (i) the lack of an equivalent to the LPAs, obliging fund sponsors to use expensive trust structures (FICAP; transparent trusts) or non-transparent vehicles such as SAPIs, and (ii) that Mexico continues to be the only (or one of the few) countries in which AFORES are prohibited from investing in private offers. This particular fact – that AFORES can only invest in the capital markets – has made raising capital in Mexico a very cumbersome and expensive endeavour.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

There is a bill in Congress to amend the AFORES investment regime that, among other matters, would permit them to invest in private offers subject to certain rules. The bill should be approved within the next year, and if such is the case, we expect a major influx of capital for private equity and venture capital. If the bill does not go through and AFORES continue to invest only in the capital markets, we anticipate a slower, yet steady, growth of the private equity/venture capital market.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

The most common structures are: the FICAP; the transparent trust; and the LPAs. For smaller funds, SAPIS are popular. No new structures have been developed.

2.2 What are the main drivers for these acquisition structures?

The main drivers are tax benefits (such as tax transparency, except for the SAPI, which is taxed at the corporate rate) and the corporate flexibility of these vehicles. Currently, Mexico has a network of approximately 70 treaties for the avoidance of double taxation and the prevention of fiscal evasion. This enables foreign investors to derive benefits attending to their own country of residency.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

At the fund level, it typically follows international trends; with a management fee of 2%–3% over committed capital and an 80/20 carry interest. At the target level, it will depend on the chosen structure, but will typically involve some type of preferred stock

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that includes standard minority shareholder protection, a preferred dividend and liquidation preference.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

It will always depend on the type of deal (whether it is seed, growth or consolidation). Minority investors in seed transactions or Round "A" financings typically look at a convertible preferred stock deal (with standard minority protection rights, liquidation preference and in later states, preferred dividends); later stage financings (growth, consolidation) will typically structure standard minority rights exclusively.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Equity allocated to management will typically vest over time, whereas compulsory acquisition provisions will typically include termination of the management agreement within a specific term or passing away of the manager before vesting terminates.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Good Leaver clauses typically include death or completion of the term for which the management equity holder agreed to stay, whereas Bad Leaver provisions will include underperformance, wilful misconduct or fraud.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

Typically, corporate governance arrangements focus on minority protection rights such as:

(i) Preferred dividends and liquidation preferences (for early stages).

(ii) Anti-dilution rights.

(iii) Rights of first refusal.

(iv) Transfer restrictions.

(v) Right to appoint a member of the board of directors of the company.

(vi) Drag- or tag-along rights.

(vii) Information rights.

(viii) Restrictions to assume secured and unsecured debt.

Arrangements are required to be publicly available in the Public Registry of Commerce, as such must be contained in the target's bylaws, which, under Mexican law, must be registered with the Public Registry of Commerce.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Yes, investors usually enjoy veto or affirmative voting rights over major decisions of the company. The veto right is usually granted at both shareholder and director level.

Veto/affirmative voting rights usually include: (i) capital contributions and reorganisation of capital; (ii) profit and dividend distributions; (iii) acquisitions and disposals not included in the business plans or the ordinary course of business; (iv) entering into agreements above certain amounts; (v) secured and unsecured indebtedness outside the ordinary course of business; and (vi) amendments to the company's bylaws, among others.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

For both levels, veto/affirmative voting rights arrangements (and any other corporate governance provision) must be contained in the company's bylaws. If the veto/voting arrangements are not included in the company's bylaws then the corresponding resolution will be invalid. This issue is typically addressed by including corporate governance provisions in the shareholders' agreement and in the target's bylaws.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

No such duties exist under law; however, private equity investors and shareholders are free to agree on their corporate relationship.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Shareholder's agreements follow the general rules for commercial agreements; therefore, pursuant to Mexican law, the parties can make any agreements and arrangements with the only restriction of not being against the law or good social standards. In this regard, it is important to consider that "against the law" may include breaching minorities' rights provided by the General Law for Business Corporations (*Ley General de Sociedades Mercantiles*). Also, shareholders' agreements cannot include provisions against the company's bylaws. For corporate governance provisions to be enforceable, they must be contained in the target's bylaws, which must be notarised and registered with the Public Registry of Commerce.

Shareholders may agree to refer dispute resolution under any law. Also, shareholders may agree to refer the controversy to local courts but to be resolved under foreign law or to foreign courts using local law. Parties may also resolve their controversies under arbitration using domestic or foreign law. In any case, referral to a foreign court/jurisdiction will require homologation to be enforceable in Mexico.

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Non-compete and non-solicit provisions are generally valid but may be challenged in court if deemed contrary to the right of free enterprise; therefore, it is advisable to limit the non-compete to a specific territory, a specific activity or market, temporary basis, and connected with confidentiality obligations. Furthermore, if the non-compete will survive the exit of the shareholder (an individual) of the company, it is advisable to include a compensation for the time that such individual will be bound to the non-compete.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

Statutory restrictions to serve as a member of the board of directors are: (i) legal entities cannot be appointed as directors, only individuals; (ii) individuals who are disqualified to perform business activities cannot be appointed as directors (i.e. public brokers, individuals convicted for property crimes); and (iii) in case of public companies, individuals who served as external auditors of the company or of the company's corporate group within 12 months before their appointment cannot serve as directors. Furthermore, directors are obliged to refrain from voting in any decision in which they may have a conflict of interest.

Corporations and SAPIs require that a statutory examiner (who is not a member of the board of directors) is appointed. The following restrictions will apply to statutory examiners: (i) individuals who are disqualified to perform business activities cannot be appointed as examiners (i.e. public brokers, individuals convicted for property crimes); (ii) employees of the company or employees of subsidiaries or shareholders of the company in certain thresholds; (iii) members of the board of directors or their relatives (at certain degrees of kinship); and (iv) legal representatives of the company.

Directors may be liable for damages and losses caused to the company due to their actions, negligence or bad faith; furthermore, they are responsible to verify that the contributions made by the shareholders have been effectively paid and that the company keeps an appropriate account. In this regard, pursuant to law, the board of directors must draft an annual report to the shareholders of the company reporting the principal policies and financial status of the company.

Unless agreed otherwise, directors are required to guarantee their performance upon their appointment (usually a security bond).

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Directors nominated by the private equity investor have a fiduciary duty with the portfolio company; therefore they must comply with the following:

(i) Confidentiality obligations regarding all the information received in connection with their position as directors of the portfolio company which must not be disclosed to any third party including the private equity investor.

(ii) In case of conflict of interests the director must refrain from voting and inform such circumstance to the Chairman and the rest of the members of the board of directors.

In this regard, it is advisable for private equity investors and portfolio companies to consider the best corporate practices set forth by the Mexican Board for Business Coordination (*Consejo Coordinador Empresarial*), including the following:

(i) Draft internal policies to align the investor's and company's interests.

(ii) Create internal corporate bodies within the portfolio company to supervise the performance of the directors.

(iii) Draft policies for the transparency of the relevant corporate decisions at the directors' level.

(iv) Appoint alternate members of the board of directors to participate in the decisions that represent a conflict of interest for the principal member.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

In terms of regulatory compliance and authorisation, private equity funds do not require registration with the National Securities Registry or authorisation/supervision of the National Banking and Securities Commission, to the extent it complies with the requirements to be considered a private offer: (i) that it is offered exclusively to institutional or qualified investors; and (ii) that the offering is made to less than 100 people.

If capital is raised through a *FICAP* or *transparent trust*, there are other bank procedures to be complied with, among others, that the trust agreement is approved by the banks' risk committee and that each investor provides a KYC.

4.2 Have there been any discernible trends in transaction terms over recent years?

No, there have not.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Private equity investors must consider that this type of transaction must be made through a public tender offer in the corresponding stock exchange. Therefore, investors must deal with: (i) strict regulation from the National Banking and Securities Commission; and (ii) investors shall consider that this type of transactions often triggers certain anti-trust regulatory obligations that must be complied with. Specific regulatory considerations depend on the structure of the target and the amount of equity to be acquired by the corresponding investor.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

The same protections that are available to any other investor in a public acquisition.

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6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

The structures vary depending on the size and dynamics of the deal, as well as the investor profiles involved in the transaction.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

It will depend on each transaction but private equity sellers usually accept standard representations and warranties with a short/medium survival period, i.e. good standing, legal title of the shares and the business, capacity and corporate authority. Buyers may rely on the due diligence of the target to negotiate certain types of warranties/ indemnities.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

The typical scope for the financial condition to meet its obligations under the private equity deal.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

In Mexico R&W Insurance used to be implemented only by multinational companies; insurers used to accept risks only of large tickets above US$300 million only if where European or US counterparties acted in an M&A deal as buyer or seller, and the law firm in charge of the due diligence of the insurance company was a US or European law firm. We have now seen a few deals of smaller tickets: US$20 million with Mexican counterparties (buyer/seller); and where the insurance company's adviser is a Mexican law firm:

(i) The policy limit is usually 10% of the ticket size.

(ii) Common exclusions include known facts, contingencies detected in the due diligence, lost profit, leakage, corruption, money laundering, war and terrorism, among others.

(iii) The typical cost for such insurance ranges from 3%–5% of the limit of liability and the retention is usually from 1%–3% of the ticket size.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Sellers will try to include limitations to potential liabilities arising from the warranties and indemnities. Such limitations can include thresholds, caps and limitations to the survival of the indemnification clauses, etc.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

It is not common for sellers to provide security for any warranties and liabilities. Nevertheless, depending on the buyer's profile, they may require certain holdback mechanisms (i.e. escrows).

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

This is typically provided through representations. Sellers would be entitled to claim damages and losses in court should private equity buyers breach their financial commitments.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are not common in Mexico. However, if the buyer is unable to obtain their debt financing and is unable to consummate the transaction due to lack of financing, the buyer may terminate the transaction upon the payment of a certain previously negotiated fee.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

Foremost, a seller should consider the relatively small size of the securities market in Mexico compared to the size of its economy. The second feature is the time and costs incurred in making an IPO.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

Lock-ups are not customarily imposed to investors in Mexico since IPO exits are not a common practice.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Dual-track exit processes are not common in Mexico. Exit strategies are focused in the sale of the target to other investors or funds.

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8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

The most common sources of debt finance in Mexico are traditional credit facilities (term loans or revolving credits). It can also involve bank loan financing for large private equity transactions.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

There are no relevant legal requirements or restrictions that affect the structure of the debt financing for private equity transactions in Mexico.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

Mezzanine financing convertible into stock has become very popular within recent years.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

There are some Mexican corporations which, under the laws of certain jurisdictions, may be treated as pass-through for tax purposes; consequently, the Mexican operating entity's items of income, gains, losses and deductions could pass through the structure to the foreign investors, and they could also receive foreign tax credits for income taxes paid in Mexico by the Mexican operating entity. Furthermore, under the provisions of certain double taxation treaties (DTC), portfolio investments (less than 25% interest) or double-tier investments are exempt from taxation in Mexico.

Regarding debt & equity transactions, investors shall consider that interest earned by non-residents would be taxable in Mexico if the capital is deemed invested in Mexico, or if interest is paid by a Mexican resident. Furthermore, Mexico has thin capitalisation rules which basically provide a three-to-one debt-to-equity ratio. Interest on non-resident related party debt exceeding such ratio would be non-deductible.

On the other hand, off-shore structures are common in private equity transactions in Mexico.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Most common arrangements for management teams are: (i) traditional vesting plans; (ii) option plans; and (iii) phantom stock plans.

Traditional vesting and option plans have similar tax consequences since they will result in income tax to the beneficiaries of the plans in two specific moments: (i) when they receive the shares derived from the plan; and (ii) when they sell such shares. In this regard, the difference between both schemes is that in the option plans, beneficiaries will decide when to subscribe the shares; therefore, they can decide when the income tax will be triggered.

On the other hand, in phantom stock plans, income tax is triggered only until the shares are sold by the company; therefore, it may be considered as the most tax-efficient plan of them all. Nonetheless, this plan is only applicable for SAPIs since no other type of company pursuant to Mexican law is able to acquire its own stock.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

Regarding capital gains, it should be considered that non-residents disposing of shares issued by a Mexican corporation would be taxed at the rate of 25% on gross proceeds or 35% on net gain, provided certain requirements are met.

Should the seller be a resident of a country with which Mexico has in effect a DTC, the aforementioned tax may be reduced or eliminated.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

No, there have not.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

A bill amending the investment regime of AFORES will be discussed in Congress in September of this year. If approved, AFOREAS will be authorised to invest in private offers, therefore releasing much needed capital to the private equity markets. This would be the major regulatory reform since the creation of the FICAP and transparent trusts.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

No, they are not.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

This depends on the size of the deal. For early stages, due diligence tends to be less comprehensive; conversely, later stage investments due diligence tends to be profound, with a scope similar to traditional M&A transactions.

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10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Yes, since 2016 there has been an increase in legislation regarding anti-bribery and anti-corruption. In this regard, there have been certain amendments to administrative and criminal regulation increasing the sanctions for public officers and including individuals and legal entities as the subject of sanctions for breaching these dispositions. Such sanctions go from fines to the judicial winding-up of the company. Therefore, private equity investors have increased the representations in shareholders' agreements and increased the review of the target's internal policies regarding anti-bribery and anti-corruption matters.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Under Mexican laws, there is a corporate veil between the investor and the portfolio companies; therefore, unless it is agreed by the investor to be held jointly responsible with the portfolio company pursuant to certain agreements between the shareholders or with third parties, the responsibility of the investor against the portfolio company is limited to the amount of participation in its equity stock.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Mexican jurisdiction is flexible; however, foreign investors shall consider that certain economic activities are reserved to Mexicans or limited to a certain amount of foreign investment; therefore, investors shall consult whether they can invest in certain activities. In the last years, Mexico has decreased certain barriers for foreign investment; for example, foreign entities may now participate in certain stages of the hydrocarbon and energy markets.

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The authors would like to thank Eduardo Montenegro for his invaluable assistance in the preparation of this chapter. His professional practice is focused in corporate and financial regulation matters, real estate transactions, M&A, private equity and venture capital transactions.

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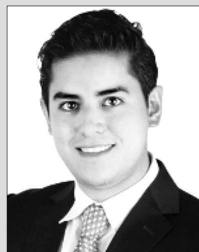

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Netherlands

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

2018 was a good year for buyout funds active in the Dutch market, where a record amount was invested in Dutch companies. Research published by the Dutch private equity association NVP shows that investors in private equity and venture capital together invested a total of almost EUR 6 billion in the Netherlands in 2018.

EUR 5 billion was spent by private equity houses in 94 buyout transactions involving Dutch target companies, which has resulted in a new record high since 2007, while the number of deals remained more or less consistent through these years. The above EUR 5 billion amount includes the buyouts of Upfield and Nouryon, which were the largest European buyouts of 2018. Nineteen of the buyout deals in the Netherlands had a value of more than EUR 150 million, constituting another record since 2007. Fifty-nine of the buyout deals in the Netherlands had a value of EUR 15 million or less, which is a slight increase compared to the 2017 numbers (i.e. 51 buyout deals).

Separately, EUR 418 million in growth capital was invested in 72 scale-ups and other fast-growing Dutch companies, and EUR 387 million in venture capital funds was invested in 293 young and fast-growth companies in the Netherlands during 2018.

Investments in growth capital saw a slight decrease in 2018 compared to 2017: EUR 481 million in 72 companies in 2018 as opposed to EUR 581 million in 90 companies in 2017. Despite this decrease, the 2018 numbers are in line with previous years.

In contrast, the abovementioned EUR 387 million in venture capital funds that was invested in the Netherlands in 2018 again constitutes a new record – the previous record was the EUR 349 million spent in 2017.

New records can also be found in the amounts raised by Dutch venture capitalists, who raised an amount of EUR 1.3 billion in 2018 – the highest amount ever. Life sciences funds appear to be particularly popular. Remarkably, a record amount of EUR 613 million is intended for early phase funding. This confirms the trend towards a bigger interest in investing in the start-up phase of companies.

The amount of funds raised in 2018 by Dutch funds for all private equity strategies (growth capital, buyout, mezzanine and general) added up to EUR 782 million, which is far below the peak of EUR 4.4 billion in 2017. This difference can be explained by the fact that there were no large Dutch buyout funds open for investors in 2018.

Finally, 2018 has been a good year for sales by both venture capital and private equity funds. In total, 86 Dutch companies, of which 24 were bankruptcies, were sold by venture capitalists at a total price of EUR 141 million. The number of private equity sales in 2018 was above average: 63 buyouts and 51 former growth capital investments were sold.

Although most PE deals in the Netherlands, by far, are private M&A deals, IPO and dual-track exits have become regular events for larger portfolio companies, and we see an uptick in PE firms taking a potential interest in publicly traded Dutch companies.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Private equity buyers and private equity deals have gained a (desirable) level of respect in the public eye. PE firms have successfully managed developing and utilising newer deal techniques, including, for instance, the use of a dual-track exit processes.

Separately, foreign PE funds often choose Dutch holding companies for their investment structure because of the extensive tax and bilateral investment protection treaty network, the Dutch participation exemption and other tax facilities in the Netherlands. Furthermore, the Netherlands is typically seen as a (politically) stable EU Member State with a well-developed legal system and a liberal economy.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

On average, private equity funds have been holding their portfolio companies for a shorter period of time recently, as compared to earlier years, and now sell off their portfolio companies after only a few years. If not this year, we expect the hold period to somewhat increase again over years to come.

Separately, warranty and indemnity insurance policies are becoming increasingly popular; in multiple private equity transactions, the seller has engaged a warranty and indemnity insurer upfront in an auction process or it was assumed that the purchaser would take on a warranty and indemnity insurance with respect to the envisaged transaction. For now (in the absence of major issues arising around

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W&I insurance policies or insurers), we expect this trend to continue.

We also expect to see a somewhat increased interest by PE houses in the public markets (including a level of "cherry picking" in case of softening public markets).

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Typically, a Dutch bid vehicle (which may or may not be held by a non-Dutch fund structure) will purchase a Dutch target entity. Generally, management will, through its own vehicle, participate at the bid vehicle – or higher – level. The bid vehicle will ordinarily acquire 100 per cent of the capital of the target entity. Although asset deals are, of course, possible, they are less customary. Although there can be the obvious potential drawbacks to minority investments, we have seen PE investors be willing to take a proactive and creative approach in a competitive market in recent years, including the structuring of minority investment deals that include targeted protections and upside sharing mechanisms.

2.2 What are the main drivers for these acquisition structures?

Typical drivers in the selection of the transaction structure are tax considerations, business continuity and the protection of assets. Such assessment is usually made based on the results of the due diligence investigation, such as contractual change of control issues, transferability of licences, IP protection and ability to effect debt pushdowns.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

At the portfolio level, institutional investors will typically invest through the fund. The fund and carried interests will typically invest indirectly via a Dutch bid vehicle (which may or may not be held by a non-Dutch fund structure). Although alternatives might be preferable in particular cases, the bid vehicle typically will be a Dutch private limited liability company (*besloten vennootschap met beperkte aansprakelijkheid*, or "*BV*"), which has full independent corporate personality while allowing great flexibility in terms of governance and equity structuring (more so than, for instance, in an NV).

The bid vehicle can borrow part of the acquisition financing, which can lead to interest deductibility when such BV becomes part of the target group's fiscal unity. The structure may, therefore, in addition to ordinary shares and preference shares, typically include (payment-in-kind) notes and other debt.

In an effort to ensure that the private equity investor(s) do not need to deal with a broad group of co-shareholders, frequently company management will participate in a portfolio company through its own single (management) vehicle at the bid vehicle – or higher – level; for instance, via a trust office foundation (*stichting administratiekantoor* or "*STAK*"), whose board could be nominated by the private equity house, but is typically managed by the portfolio company's senior management itself. In case of the use of a STAK, that vehicle will hold the shares in the capital of the company and issue depositary receipts to management (whether directly or indirectly via managements holding companies). Alternatively, company management participants and other key employees may hold their (collective) stake through stock ownership in a senior management-controlled BV or other corporate that would hold such stake.

We note that, sometimes, management participants may also directly hold non-voting shares in the BidCo or portfolio (BV) company itself. However, in that case, the shares held by management will typically be structured as non-voting shares. Under Dutch law, non-voting shares still (mandatorily) carry the right to be called for and attend shareholder meetings. As a result, the presence of non-voting stock may somewhat complicate shareholder decision-making (i.e., block shareholder action by written consent in the absence of cooperation by the holders of the non-voting stock in any specific instance). As a result, depositary receipt structures (as described above) tend to be preferred over non-voting stock structures.

Typical drivers in the selection of the equity structure are facilitation of effective management, alignment of interests with those of the fund investors (both at the fund management and portfolio company key employee level), and return on capital and exit in an efficient manner from a governance, management tools and tax point of view.

Management is often offered the opportunity to invest in the institutional strip along with (or similar to) the private equity's institutional strip. In addition, in order to further stimulate management's performance, management may be offered economic incentives to pursue (or exceed) a specific optimistic exit valuation, such as sweet equity (e.g., additional ordinary shares as a result of which the value of management equity in relation to the remaining shareholder(s) is increased in case of success beyond expectations of the investment) and sometimes even a ratchet (usually in the form of additional economic rights attached to the managers' preferred shares).

The provision of a loan to management (which may be provided on a non-recourse basis) to finance the acquisition of such equity stake is not uncommon.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Customary minority protection will typically be negotiated, including veto rights in respect of selected, material corporate actions, (frequently) proportionate board representation (including committee seats, where appropriate), and information rights. Furthermore, the private equity investor would generally specifically structure (and negotiate comfort with respect to) its liquidity event, in order to ensure that its investment is safeguarded.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

The typical range of equity allocated to management can be between 0 per cent and 20 per cent, the latter being considered exceptionally high. With a view to the participation exception under Dutch tax law, management would usually want to obtain at least 5 per cent of the nominal paid-up share capital or the voting rights.

Apart from outright (senior) management equity participation on an unrestricted basis from day one, key employees/management may be granted (either) restricted stock, subject to a call option that – for

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instance – expires in tranches of 20 per cent each over a five-year period, or stock options subject to a similar vesting period.

Vesting usually occurs between zero and five years, whereby the range of zero to three years is considered most typical. Non-vested shares are typically valuated against a discount or even against nominal value, while vested shares are normally valuated against fair market value.

Also, the management participation vehicle or direct participants, as the case may be, will typically be party to a shareholders' agreement entered into with the private equity firm(s), providing – among other things – for customary drag and tag along provisions, as well as non-encumbrance commitments, aimed at ensuring a smooth PE-led exit process.

Common compulsory acquisition provisions are commonly triggered, in short, when a management equity holder:

- ceases to be a managing director of, employee of, or consultant to the company;
- becomes insolvent, subject of an application for a declaration of bankruptcy or suspension of payments (*surseance van betaling*), enters into bankruptcy or suspension of payments, has a liquidator appointed to it, or becomes subject to insolvency proceedings; or
- is in breach of material governance provisions.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Stock options and restricted stock grant agreements will typically contain (internationally customary) good leaver/bad leaver provisions.

In common practice, a management equity holder will be deemed a bad leaver if it ceases to be a managing director, employee or consultant of the company pursuant to:

- the termination by such management equity holder of his employment agreement or consultant agreement (as the case may be), or resignation by him as a managing director, other than for reasons of *force majeure* (*overmacht*) on the part of such management equity holder; or
- the termination of the management equity holder's employment or consultant agreement (as the case may be) by the company for cause, i.e. the situation in which the employment or services agreement governing the position of the management equity holder may be terminated or the management equity holder may be dismissed for an urgent cause justifying summary dismissal (*dringende reden*, as meant in Section 7:678 of the Dutch Civil Code), attributable to the management equity holder.

Usually, a management equity holder will be deemed a good leaver if such management equity holder ceases to be a managing director, employee or consultant of the company pursuant to:

- the company terminating his employment agreement or external consultant agreement (as the case may be), by serving notice (in accordance with the terms of that contract) in circumstances where he is not in breach, nor has been in breach, of his contract;
- dismissal by the company which is determined by an employment tribunal, or court of competent jurisdiction, from which there is no right to appeal, to be wrongful or constructive, and where he is not in breach, nor has been in breach, of his contract;
- release from or dismissal as a managing director, employee or external consultant of the company in circumstances where he is not in breach, nor has been in breach, of his contract; or
- the private equity investor confirming in writing that he is a good leaver.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

Dutch law allows for the creation of either a single-tiered board governance structure, or a two-tiered board structure. In the case of a single-tiered board structure, the board could consist of either solely executive directors, or both executive and non-executive directors. In the case of a two-tiered board structure, the company's articles of association will provide for the creation of both a management board (solely comprised of executive directors) and a supervisory board (solely comprised of non-executive directors).

Apart from supervising the business through the exercise of shareholder rights, private equity firms typically seek non-executive board "representation". Historically, this was frequently done through the appointment of one or more trusted individuals on the supervisory board, in a two-tiered structure. Such two-tiered structure was particularly popular (and, in fact, in the past, was mandatory for certain larger companies) as the explicit possibility to appoint non-executives in a single-tiered board structure was only reflected in the Dutch civil code relatively recently.

Prospective director liability exposure is (still) typically perceived as more limited for a supervisory director in a two-tiered board structure in comparison to a non-executive director in a single-tiered board structure (as a supervisory board member would – as opposed to a non-executive in a single-tiered board structure – not form part of the company's sole "managing" board). However, we believe that the single-tiered board structure is gaining in popularity in PE transactions, because (i) it allows the PE house's "representatives" direct access to all management/board information and a more direct handle on day-to-day business developments, and (ii) the structure tends to be more familiar to U.S., UK and other international investors.

The general governance arrangements are typically laid down in the articles of association. There is a statutory obligation to file the articles of association with the trade register of the Dutch chamber of commerce and as a result the general governance arrangements laid down in the articles of association are publicly available. There is no statutory requirement to file any – more detailed – governance arrangements laid down in, for example, board rules or shareholders' agreements.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Incorporation of a list of reserved matters in the shareholders' agreement, the articles of association of the portfolio company and/or the portfolio company board rules is customary. As a general matter, such rules do not directly affect the rights of third parties. Accordingly, should one or more executive board member(s) exceed their (internal) authority by binding the company to a commitment without first obtaining the required internal approval (be it at the non-executive or at the shareholder level), the company will

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generally be bound. However, if an executive would have done so in breach of the company's articles of association, it may be relatively easy to establish director liability *vis-à-vis* the company in relation thereto. Accordingly, reserved matters lists tend to be effective tools. In cases of minority investments, customary minority protection will typically be negotiated, including proportionate board representation and veto rights in respect of selected, material corporate actions.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

At the shareholder level, as long as shareholders do not infringe basic standards of reasonableness and fairness that should be observed *vis-à-vis* other stakeholders in the company, private equity investors are free to vote in their own particular (shareholder) interests. When voting at the board level, a nominee director – like any other director – must, in the fulfilment of his or her duty, act in the interest of the company and its business as a whole (as opposed to the interest of a particular shareholder). The corporate interests that the director must seek to safeguard consist of the interests of all stakeholders in the company (including all shareholders, but also employees, creditors, etc.). In practice, board members may seek legal guidance in particularly sensitive situations, but mostly this tends not to be a real issue in typical portfolio company situations.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

Under Dutch law, a majority shareholder (such as a PE house in a portfolio company) should observe basic standards of reasonableness and fairness towards other shareholders and their *bona fide* interests. This, essentially, means that the majority shareholder should not exercise its rights in an abusive manner. Having said that, the overriding rule is that a shareholder is free to act in its own interests and it does not owe any fiduciary or similar duty to any other shareholder.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Dutch company shareholders' agreements are relatively flexible in terms of content. In order to make certain commitments fully/directly enforceable (as opposed to potentially creating "just a breach of contract"), it may be preferable to lay down certain commitments in the portfolio company's articles of association as well. However, Dutch company articles of association are more restrictive than shareholders' agreements, both in form and in substance. In addition, the full content of Dutch companies' articles of association are publicly on file with the trade register, while shareholders' agreements can be kept fully confidential.

A shareholders' agreement with respect to a Dutch portfolio company may be governed by a law other than Dutch law, and jurisdiction in the Netherlands is not required. We note that the articles of association of a Dutch company (which will in any case also contain a substantial number of the company's governance provisions) will mandatorily be governed by Dutch law, and disputes involving corporate duties under the law or the articles can be brought in the Dutch courts, irrespective of the governing law and jurisdiction provided for in the shareholders' agreement. In connection therewith, and recognising the record of the Dutch courts, many Dutch as well as non-Dutch private equity investors have been happy to provide for Dutch law and jurisdiction in their shareholders' agreements. However, we frequently see alternative arrangements as well.

One of the more restrictive covenants in the shareholders' agreement is the non-compete. The restrictions are driven by EU rules and regulations and are mainly related to the duration of the non-compete after the termination of the shareholders' agreement and the geographical and product scope of the non-compete.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

Non-executive directors (whether in a two-tiered structure or in a single-tiered structure) are barred from taking executive action and supervisory board members cannot sit on the company's management board. When a supervisory board member takes any executive action, he or she exposes him or herself to increased levels of potential liability, as if such person is a management board member.

At the level of each board, the duties of the board members are collective in nature, which means that if the board consists of more than one member, the members of the board should exercise their decision-making powers collectively. As a general rule, collective responsibility of the board may result in joint and several liability. A board member may avoid liability by proving that he or she was not culpable for the shortcoming(s) of the board and that he or she was not negligent in taking action to avert the negative consequences of the shortcoming(s).

Directors may be held personally liable – by the company, but not by its shareholders on behalf of the company (i.e., no U.S.-style derivative suits) – for serious violations of their specific statutory duties and general good faith obligations (as developed in case law). The standard to which directors are held is that of a reasonably acting "business person".

When director duties are fulfilled with reasonable diligence, and appropriate D&O coverage has been taken out, we believe it is fair to say that the potential risks and liabilities for a director nominated by private equity investors to the board of a Dutch portfolio company should be deemed reasonable and manageable by international standards.

For a brief description of certain (limited but) potential risks and liabilities for private equity investors that have nominated directors to boards of Dutch portfolio companies, please refer to our answer to question 10.5 below.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

The Dutch director conflicts of interest rules are relatively

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restrictive. In principle, a conflict of interests only arises if a director has a personal financial interest in the matter concerned. Accordingly, a conflict of interests is not necessarily deemed to arise if a director does not have a personal (and substantial) financial stake in the outcome of the matter. In cases where there is a conflict of interests, the relevant board member cannot take part in the board decision-making process on the matter concerned.

It follows from the above that under Dutch law, a director is not necessarily disqualified from the board decision-making process in case of a (potential) conflict with either the party that nominated the director or another portfolio company where the director serves on the board as well.

Apart from the above-described formal compliance with the Dutch conflict of interests rules, each director should continuously ensure that he or she acts independently and in the interest of the relevant portfolio company and all of its stakeholders. Private equity firms may want to ensure that they do not nominate individuals for board positions in respect of whom conflicts of interest are overly likely to arise. Moreover, parties should ensure that any particular directors' board positions at other (portfolio) companies do not give rise to confidentiality or competition concerns. In addition, private equity firms are well advised to monitor that they either have sufficient and appropriate nominees on the board to ensure that they continue to feel comfortable with decision-making when one or more of their nominees abstain from a decision-making process as a result of a conflict of interests, or ensure that the matter concerned will be raised to the shareholder level. It is not atypical to require that any particular resolution will in any case require the affirmative vote of a PE firm-nominee, in the absence of which it must be raised to the shareholder level.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

The major issues impacting the timetable for private transactions in the Netherlands mainly relate to the involvement of the works council in the transaction and competition clearance. Formally, the works council of a company should be provided with the opportunity to form an opinion on the envisaged transaction at a stage in the transaction process at which the opinion could potentially have an impact on the outcome of the transaction. For IPOs to be listed on a regulated market, an additional issue impacting the timetable consists of prospectus preparation and dealings with the regulator, whose approval of the prospectus typically dictates the entire timetable. Fortunately, the Netherlands Authority for the Financial Markets (*AFM*) has proven to be willing to be quite cooperative and takes a constructive approach, making it relatively easy for parties to set a clear and manageable timetable. For public-to-private transactions, the public bid rules, together with the competition process, will typically dictate the timetable.

4.2 Have there been any discernible trends in transaction terms over recent years?

Following the financial crisis, the market turned from a sellers' market into a buyers' market, and has now largely turned into a sellers' market again. Accordingly, we are seeing a good number of auctions and we tend to see competitive bidding processes. As a result, deals frequently are done on quite seller-friendly terms and are completed in relatively short timeframes.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

PE firms tend to face no greater challenges in public bid situations than strategic bidders. In fact, although typically the relevant PE house's entire portfolio needs to be considered for antitrust review purposes, actual issues in this respect tend to be more serious (potentially leading to an extended bid period) for strategic buyers. In the case of a cash bid (of course, likely in the case of a public-to-private deal), the bidder must confirm "certain funds" when it files its bid document with the AFM for approval. This is not necessarily more onerous to a PE house than to a strategic bidder offering cash.

We refer to Houthoff's contribution in Global Legal Group's *The International Comparative Legal Guide to: Mergers & Acquisitions 2019* for more extensive details on the Dutch public bid rules and timetable.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

Typical commitments to provide protection to buyers in public acquisitions in the Dutch market are break fees (including reverse break fees, although less typical), no-shop provisions, a fiduciary out for the target board only in the case of a superior bid that, in any case, exceeds the offered bid price by an agreed upon minimum percentage, and matching rights.

With respect to break fees, there are no specific rules in place, nor is there definite case law. A break fee of around 1 per cent of the target's equity value in a fully Dutch deal is typical, but, in particular where foreign parties are involved, higher break fees may be agreed. It is, however, generally believed that excessive break fees may conflict with the target board's fiduciary duties and could qualify as a disproportional anti-takeover defence if they would frustrate potential competing bids.

No-shop provisions (subject to fiduciary outs) are commonly found in merger protocols. However, before agreeing to such provisions, the target board should have made an informed assessment of available alternatives to the bid, and on that basis have determined, exercising reasonable business judgment, that the bid is in the best interests of the company and its stakeholders.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

The predominant structure for private equity transactions in the Netherlands is similar to the structure prevalent in other jurisdictions such as the UK and the U.S. The transactions (typically straight buyouts) are commonly funded partially by one or more banks and partially by private equity funds together with the management of the target company. The leverage ratio is dependent

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on the current market conditions and the projected cash flows of the target company. Due to the market conditions following the financial crisis, a clear trend of lower leverage ratios in private equity transactions has clearly been visible, but in more recent years the tide appears to have turned again.

In terms of consideration, cash deals tend to be preferred. Reinvestment by management and certain other sellers (including, for instance, influential local investors) may be (strongly) encouraged (or demanded). With regard to determining the purchase price, private equity funds in the Netherlands traditionally prefer locked-box mechanisms (focused on working capital) over closing accounts, although the latter became more popular during the downturn due to the resulting increase in risk aversion of market participants (whereby, also in this respect, the tide turned again).

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

In line with the prevalent practice in other jurisdictions, private equity sellers in the Netherlands tend to insist on offering very limited warranties and indemnities, and frequently limiting exposure to any business warranties to an amount equal to an escrowed amount. However, in recent years and from time to time, private equity sellers have offered warranties and indemnities beyond the standard authority and title warranties, etc., in an effort to get a deal done. In that event, we have seen that warranty and indemnity insurance (with a preference for buyers' insurance, whereby the premium is sometimes deducted from the purchase price) has increasingly become popular and can fill the gap between the comfort sought by the buyer and the exposure the private equity seller is willing to accept.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

They are in line with UK practice.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

The warranty and indemnity insurance market is increasing in size and importance in the Netherlands, amongst others, as a result of more sophisticated and tailor-made insurance products (now also covering, for instance, tax matters) and lower insurance premiums. Insurance brokers are actively approaching deal-makers in the Netherlands. Currently, more buyers are making use of warranty and indemnity insurance products, especially in controlled auction situations, in which case the insurance is seen as covering certain risks and could – as a result – potentially have a positive impact on valuation, giving a bidder a competitive edge. The costs of such insurance depend on the size of the target companies and the desired coverage.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Please see question 6.2 above.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Although private equity sellers tend to push back on providing security for any warranties/liabilities, (limited) escrow arrangements are agreed from time to time. When buying, private equity houses tend to take a willing look at warranty and indemnity insurance as a partial alternative to seller-provided security. Comfort/security from the management team is frequently not seen as desirable ("you don't want to sue your new partners"), and in fact comfort can be sought from sellers that they will not seek recourse from continuing management team members. Still, in case of a strategic seller, depending on the sale dynamic and competitiveness of the sale process, it is not entirely uncommon for a private equity buyer to seek a more extensive set of warranties and corresponding security for those warranties.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Private equity buyers typically provide comfort by means of an (internationally) customary debt commitment and/or equity commitment letters.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

As mentioned above, reverse break fees are less typical in the Dutch private equity market, both in public and private transactions.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

IPO exits are still relatively rare in the Dutch private equity market (albeit, markedly more popular in recent years as a result of the IPO window having been open for an extended period of time and a well-performing Euronext Amsterdam). Also, we have seen a good number of dual-track exit process deals. An obvious major drawback of the IPO exit is the fact that the customary lock-up arrangements, prevalent in any IPO, as well as market dynamics, deprive the private equity firm of the opportunity to sell its stake in its entirety on the date of listing. Apart from market and disclosure risks, from a legal perspective, the main challenge remains preparing the target company to become a public company. In deals where a PE house may not have sole control, we have seen that it may be key to ensure – in the early stages of the PE investment, far before an IPO transaction should actually be implemented – that the shareholders' agreement (and other contractual framework) truly allows the PE house to complete whatever is necessary in order to complete the public offering and listing.

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7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

This is in line with UK practice.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

The majority of IPO exits in the Netherlands are preceded by a dual-track process. Although we have seen a remarkable number of IPOs pulled at the last minute recently (while the record on secondary buyout deals being completed appears strong), we still expect that the dual-track exit strategy will continue to be reasonably popular in the years to come. In some cases, the dual-track exit processes were prepared in great detail and were run pretty much until the end. In other cases, we have seen the IPO as the leading option while the seller remained willing to sell privately. Having said that, ultimately, most of the dual-track exit processes of late appear to conclude with a sale rather than through an IPO.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Debt finance for Dutch private equity deals is largely made available in the form of senior debt and, to a lesser extent, mezzanine finance, with funding/valuation gaps commonly being filled with vendor loans and/or earn-out arrangements.

The senior debt is largely sourced from Dutch banks and (to a lesser extent) from US/UK banks or German banks. Mezzanine finance is to a large extent sourced from specialised mezzanine-debt funds and, to a lesser extent, by Dutch or US/UK banks. Stapled financing (i.e., where the seller pre-arranges an acquisition loan for the benefit of the buyer) may also occur depending on the transaction, but seems to be less common.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

With respect to private companies with limited liability (*besloten vennootschappen met beperkte aansprakelijkheid*), the financial assistance restrictions have been abolished as of 1 October 2012. This means that there is no longer any specific legal provision that renders void financial assistance transactions by a Dutch private company with limited liability for acquisition loans, and no specific deal structuring is necessary in this regard. The financial assistance rules with respect to public companies (*naamloze vennootschappen*) remain in force. Succinctly put, the consequence of these rules is that a public company or its subsidiaries (i) are not allowed to provide security or guarantees for financing that is used to acquire the shares in such public company, and (ii) are restricted in providing loans to third parties to acquire shares in such public company. Common ways of addressing the financial assistance rules include ensuring that the acquisition financing: (i) is provided to the target public company which can, along with its subsidiaries, provide security for such loan after which the proceeds of the loan are upstreamed by the public company to the buyer, which then purchases the shares in the public company; or (ii) is provided to the buyer and the buyer enters into a statutory merger (*juridische fusie*) with the target public company after the shares thereof have been acquired, following which the merged entity can provide security for the loan. Please note, however, that the number of private companies with limited liability existing in the Netherlands far exceeds the number of public companies. The practical consequence for private equity transactions of the continued existence of financial assistance rules with respect to public companies is therefore not great. Although the importance of financial assistance rules under Dutch law is therefore limited, it should be noted that general principles of Dutch law such as corporate benefit, fraudulent conveyance and board duties towards the company and its stakeholders remain important to consider when resolving on whether or not to enter into financial assistance transactions.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

Bank and/or corporate bonds remain the most important form of corporate debt financing in the Dutch market, which is also the case for the small and medium-sized companies. For smaller financings, the Dutch market has, however, seen a marked rise in crowdfunding, financing via fintech companies and other alternative financiers (business angels, credit unions, etc.).

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Dutch Coop/BV or CV structures are generally used for transactions where private equity firms invest in the Netherlands or abroad. This enables private equity investors to invest in a tax-efficient manner if the structure suits the main business purpose of the private equity investors.

One of the key features of a Dutch structure is that it can benefit from the participation exemption. The Dutch participation exemption provides for a full exemption of corporate income tax in relation to income (dividend and capital gains) derived from (Dutch and non-Dutch) qualifying subsidiaries.

Dividend payments are subject to 15 per cent dividend withholding tax in the Netherlands. However, in many cases the dividend withholding tax rate is reduced or cancelled due to applicable tax treaty rates. In addition, if structured properly and certain requirements are met, distributions of profits by a Coop are generally not subject to withholding tax.

Capital gains realised on the sale of an interest in a Coop/BV by either a Dutch or foreign entity are generally not subject to corporate income tax unless certain anti-abuse provisions are triggered. Non-Dutch resident entities are generally only subject to corporate income tax on income and capital gains realised in respect of shareholding in a Dutch BV or membership interest in a Coop if:

- such shareholding or interest is attributable to an enterprise or permanent representative of the shareholder in the Netherlands and the Dutch participation exemption does not apply to such shareholding or interest; or

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- a shareholder holds a substantial interest in the Dutch entity (generally a direct or indirect 5 per cent shareholding or interest), such substantial interest is held with the main purpose or one of the main purposes to avoid Dutch income tax or dividend withholding tax of another person, and such substantial interest is the result of a (series of) artificial arrangement(s) that is/are not genuine (e.g., not based on sound business principles).

Dutch law contains an earnings stripping rule as of 1 January 2019. Therefore, specific anti-abuse provisions apply on the tax deductibility of interest both on third-party debt as well as related party debt. Generally speaking, these provisions limit the deduction of interest to 30 per cent of the (fiscal) EBITDA of a company, with a EUR 1 million threshold. Other specific anti-abuse provisions may apply as well.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

A manager who has a certain carried interest in the acquisition structure qualifying as a so-called "lucrative interest" as mentioned in question 9.3 below, may structure its interest through an intermediate entity in such manner that its capital gains and income qualify for specific taxation in Box 2 (at a flat rate of 25 per cent). Such treatment will be available if the following conditions are met:

(i) the lucrative interest is held indirectly through a (Dutch or non-Dutch) holding company in which the taxpayer holds a substantial interest (i.e., an interest of at least 5 per cent of a certain class of shares); and

(ii) at least 95 per cent of the annual lucrative interest income (i.e., dividends and capital gains) derived by the (Dutch or non-Dutch) holding company is distributed to the taxpayer within the calendar year of realisation (the "distribution requirement"), unless this is not possible due to legal restrictions. In that event, distribution has to take place immediately upon the moment that the restrictions no longer apply.

For foreign managers, it is important to observe the applicability of a double tax treaty which may prevent or limit the Netherlands from levying Dutch tax on a carried interest.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

Managers who obtain a qualifying carried interest in the acquisition structure in relation to their Netherlands-based work activities will fall within the scope of the so-called "lucrative interest" rules for Dutch income tax purposes. Income and capital gains derived from a lucrative interest are taxed at progressive rates up to 51.95 per cent, unless such a lucrative interest is held indirectly through an intermediate holding vehicle and some other conditions are met (see question 9.2).

The lucrative interest rules apply if (i) a taxpayer owns an equity instrument, (ii) such equity instrument is held with the purpose of remuneration for the activities performed, while (iii) the equity instrument requires no (or only a limited) capital investment that due to gearing may result in a potential return that is disproportionate to the capital invested.

Generally speaking, equity instruments qualify as a lucrative interest if:

(i) the equity instrument is a class of shares that is subordinated to other classes of shares and the paid-in capital of the subordinated class is less than 10 per cent of the total paid-in capital of the company concerned; and

(ii) the equity instrument consists of preference shares bearing an annual yield of at least 15 per cent.

Loan receivables bearing a yield that is dependent on, for example, the profits or turnover of the business or other managerial or financial targets can also qualify as an equity instrument qualifying as a lucrative interest.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

Apart from the earnings stripping rule, mentioned in question 9.1, it is envisaged that, as of 1 July 2019, the Updated Ruling Policy enters into force. The Updated Ruling Policy will apply to all cross-border rulings. Compared to the current ruling policy, the Updated Ruling Policy will considerably complicate the process of obtaining a ruling (whether an Advance Tax Ruling, Advance Pricing Agreement, or another ruling). Requesting companies should also be aware that if a ruling is obtained under the Updated Ruling Policy, an anonymised summary of this ruling will be published by the Dutch Tax Authorities.

On 26 February 2019, the European Court of Justice (*ECJ*) ruled that a non-codified general anti-abuse principle underlying EU tax law applies to certain private equity structures. The ECJ ruling affects a taxpayer's ability to rely on Directive benefits (i.e. withholding tax exemptions), if the recipient of the income under review lacks sufficient substance in its country of residence.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

There are no significant changes or expectations with respect to regulation, other than as set out in question 10.2 below.

The key legal regime that normally applies to private equity is the Dutch regime implementing the Alternative Investment Fund Managers Directive (2011/61/EU), or AIFMD. Pursuant to this regime, management companies of private equity funds are normally subject to regulation. Private equity investors themselves are not directly impacted by this regime, as the regime only regulates management companies (so-called alternative investment fund managers or AIFMs) and funds (or alternative investment funds or AIFs). Certain exemptions apply, the most important exemption being true family offices and sheer corporate holding structures.

Pursuant to the AIFMD, management companies are subject to registration or licensing depending on the size of all funds managed. If this is less than EUR 500 million on an aggregate basis, and assuming that the funds are closed-end for at least five years and no leverage at fund level applies, a Dutch management company is subject to registration with the AFM only. When registered, certain reporting requirements need to be met. A large part of the Dutch

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private equity fund management companies is subject to this registration. If the aforementioned threshold is exceeded, however, a management company is subject to licensing and compliance with certain ongoing requirements. Among such ongoing requirements is the requirement to publish a prospectus, meeting the requirements set by the AIFMD (and, in the case of retail marketing, the Dutch regime on retail marketing) and rules relating to holdings and control of non-listed companies. These rules include a duty to disclose acquisitions of interest to the AFM when surpassing certain thresholds, and a prohibition on asset stripping during the first 24 months following acquisition of control (>50 per cent of the votes) of targets of a particular size by means of dividend payments, capital reduction, repayment on shares and repurchase of shares. As a result, PE transactions may be impacted if this licensing regime applies.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

While there is no general, formal regulatory scrutiny on national security grounds, certain industries are (heavily) regulated such as the financial industry, the telecommunications industry, the health care industry, the nuclear industry, the defence industry and the energy industry (e.g., gas, electricity and petroleum). As a result, private equity investments in such industries normally require prior screening of the acquirer (and its shareholders) or similar arrangements. This will imply involvement of the competent Dutch regulator and may require that an approval process is completed prior to completion of the acquisition.

The Dutch government is currently conducting an analysis in certain of the vital sectors referred to above, with the purpose of identifying the risks to national security in the event of acquisitions by foreign parties within such industries. Based on the outcome of such analysis, it will be determined whether the existing instruments are appropriate safeguards of whether further measures will be required. A proposed law that renders ownership of (tele)communications companies subject to heightened government scrutiny has been submitted to (and is debated in) parliament at this time.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

Depending on the complexity of the business or the importance of a certain legal field to the business (e.g., environmental, intellectual property, securities/regulatory), levels of legal due diligence vary. Compliance has become an increasing focus over recent years. The legal due diligence process is commonly conducted by outside counsel. In controlled auctions, it is not uncommon that an extensive legal vendor due diligence report is prepared, on which reliance can be given (in addition to the bidder/buyer's own – confirmatory – due diligence). Many private equity buyers prefer a focused, high-level legal due diligence exercise resulting in issues-based reporting. Legal due diligence efforts are typically undertaken within weeks, whereby – when needed – substantial efforts can be undertaken and finished in short timeframes, whether in an effort to contain costs (e.g., in competitive auction processes), to allow for pre-emptive bidding or to allow for bidding in emergency processes (e.g., insolvent seller).

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Apart from Dutch law compliance checks, when investing in the Netherlands, private equity houses tend to be very much aware of the U.S. and UK anti-bribery and anti-corruption rules, and sensitivity to potential issues in this respect tends to form an integral part of the diligence process. Contractual comfort sought in this respect tends to be in line with international practice.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

If there is intense involvement by the private equity house (for instance, through a combination of information and consent rights laid down in the governance documentation, and *de facto* intense involvement in the company's management, strategy and controls) causing the PE house to exercise decisive influence over the strategy and/or operations of a portfolio company, such involvement may lead to a duty of care *vis-à-vis* the company's creditors if the PE house knew or should have known that – without its appropriate action – the portfolio company would end up in insolvency. Accordingly, it may be helpful to aim for an appropriate balance between active involvement and reliance on senior management.

Apart from the above, we refer to the EC power cable cartel case (EC, IP/14/358, 2 April 2014) in which the PE arm of a large investment bank was held jointly and severally liable by the European Commission in relation to that investment bank's former ownership of a power cable manufacturer, which, obviously, may have ramifications for PE houses active in the Netherlands as well.

Assuming no other ties (except for the fact that they are ultimately held by the same PE fund) and, accordingly, assuming among others that no contractual comfort is provided for each other's debt or the like, there is no particular basis under Dutch law that would make a portfolio company liable for the liabilities of another portfolio company.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

In May 2019, the Amsterdam Court of Appeal ruled that a French private equity investment company had committed misuse of law (*misbruik van recht*) by setting up a financial structure in connection with the acquisition of lingerie chain Hunkemöller in 2011 with the sole purpose of tax avoidance.

The private equity investment company used a shareholder loan of EUR 61.4 million for the acquisition of Hunkemöller which had no other use than giving ground to extremely high interest rates (EUR 8.1 billion over the full term of the loan). In France, income on

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interest is not subject to tax. Pursuant to Dutch tax law, interest can be deducted from tax. The purpose of the aforementioned loan was to ensure that the profitable Hunkemöller would be making loss on paper and that therefore no profit tax had to be paid.

Hunkemöller intended to deduct more than EUR 27 million over the first three years after the acquisition in interest from tax. However, The Amsterdam Court of Appeal now ruled that Hunkemöller cannot deduct this amount.

The tightened restrictions on interest deduction make it more difficult for private equity companies to avoid tax, but not impossible.

It is expected that Hunkemöller will take an appeal against the ruling of the Amsterdam Court of Appeal to the Supreme Court.

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Nicaragua

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

The high influx of direct foreign investment received by Nicaragua during the past few years has created an international private equity (PE) market where foreign entities own local companies and where these foreign entities sell their Nicaraguan companies to other foreign entities. Thus, PE transactions are commonly structured subject to foreign laws (typically New York). Nicaraguan laws are very broad and all types of PE transactions are permitted, with the most common types being those that have the least tax impact, which may vary on a case-by-case scenario.

Despite the socio-political crisis that began in April 2018, some PE transactions have taken place in the last few months, like the acquisition of Spanish telecommunications company "Telefónica", which operates Movistar by "Millicom" which operates Tigo. However, for now the forecast of future trends is difficult to assess due to the political and economic uncertainty that the country is still experiencing.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Relevant PE transactions have remained generally inhibited by the socio-political crisis in Nicaragua which has negatively impacted the economy. However, there have been some successful transactions despite this. Foreign investors that have an appetite for opportunities in emerging markets may enter into Nicaragua in the next few months, as the price of certain assets has lowered in the last year.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

The trends may vary according to how the socio-political situation is resolved. If a political solution is agreed this year prompt recovery should follow. Otherwise, the environment of uncertainty for foreign investment may prevail for some more time.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Special purpose vehicles (SPVs) are commonly used to acquire Nicaraguan companies in PE transactions. Whether these SPVs are constituted in Nicaragua or in another foreign country may vary depending on the complexity of the transaction.

2.2 What are the main drivers for these acquisition structures?

Tax considerations are the main drivers for these types of acquisitions. There are, however, other drivers such as solutions to the agency problems, limitations of liability, asset protection, and regulatory compliance that advocate for this type of structure.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

The equity is commonly structured through one class of shares in which the PE fund will be the majority shareholder through a SPV. It is common to have institutional investors as the main shareholders of the assets. The structure is commonly defined according to international standards which usually requires confirmation from local counsel regarding local regulatory aspects.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Yes, if PE investors are taking a minority position, there are relevant protections that need to be considered. A Shareholders Agreement subject to New York law is advisable to protect the rights of the minority shareholders, including rights of veto of certain decisions, termination rights in case of deviation of corporate purpose or traditional business, etc. However, it is uncommon for a PE investor to take a minority position in Nicaragua. Usually it procures a majority stake in the newly acquired company.

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2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Existing key management are usually offered retention bonuses and in some cases, options for the acquisition of shares in the company. This policy varies for each case.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Such treatment is usually defined and governed by the Stock Purchase Agreement or the Shareholders Agreement entered at the time of the acquisition and is usually subject to foreign law.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

PE portfolio companies are not obligated to have specific governance arrangements. Therefore, governance arrangements are typically established in Shareholders' Agreements, the company's by-laws or its articles of incorporation.

One of the advantages of having Shareholders Agreements are that they do not need to be published since these agreements will not be registered in the Public Registry nor require a judicial process for approval for them to take effect.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

There are no legal provisions that prohibit any shareholder from enjoying veto rights over major corporate actions. Although these veto rights typically take the form of having special quorum and reinforced majority vote requirements to take major corporate actions regulated in the company's by-laws or articles of incorporation, there may be some veto rights that the PE investors and/or their director nominees could typically enjoy through Shareholders Agreements which could be subject to the laws of New York.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

There are no legal limitations that affect the effectiveness of veto arrangements other than the ones agreed upon the shareholders through a Shareholders Agreement or the company's by-laws or articles of incorporation. In any event, it is advisable that the main veto rights are stipulated in the Articles of Incorporation and/or by-laws of the company in order to facilitate their enforcement.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

There are no legal duties owed by PE investors to minority shareholders (and *vice versa*) other than the ones that may be constituted by mutual agreements through Shareholders Agreements or in the Articles of Incorporation. Under local law, all shareholders have equal rights, unless it is agreed differently.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

These agreements are typically governed by the laws of New York. Shareholders Agreements are binding only between the contracting parties in Nicaragua and they are free to determine the extent and scope of the agreement. Nonetheless, a corporate action taken against a provision established in a Shareholders Agreement will still be valid but the party that violates the agreement may be liable due to the violation of the agreement.

Non-compete and non-solicit provisions are not subject to limitations or restrictions in Nicaragua.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

Generally, the directors of a company must be chosen among their shareholders. These shareholders may appoint natural persons to permanently represent them on the Board of Directors. Only certain types of regulated entities can have directors that are not shareholders of a company.

Because the shareholders must generally be the directors of the companies, they share the same risks and liabilities as their natural person representative in the Board of Directors. The members of a Board of Directors are not severally nor jointly liable for the obligations of the company but will be held personally and jointly liable towards the company or towards third parties for the lack of execution of its legal mandate, for the violation of the articles of incorporation and for the violation of other legal provisions.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

The Nicaraguan Commercial Code does not address specific agency problems. Generally, the directors of a company may not personally exercise any acts of commerce or industry like the ones exercised by the company unless there is an express authorisation given through a Shareholder Meeting Resolution.

Certain financial entities hold special conflict of interest regulations for the Board of Directors that specify that directors must abstain

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from voting when the Board of Directors´ decision may potentially cause a conflict of interest.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

Some industries, like financial institutions, require the prior approval of the local regulator (Superintendence of Banks). Others, like brokerage insurance companies, only require a post-closing notification to the local regulator. In the case of a concentration of a dominant position as a result of a proposed transaction prior approval is required for the antitrust authority. This process may take between six to 12 months, depending on the complexity of the market, the transaction, etc.

4.2 Have there been any discernible trends in transaction terms over recent years?

Many transactions have been completed by the acquisition of a majority interest of a holding company of the local assets incorporated abroad. This obligates to analyse foreign regulations to the transaction as well as local rules, which include regulatory approvals, corporate approvals, taxes, etc.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Public-to-private transactions (and their financing) are not performed in Nicaragua as there are almost no companies that might be considered public under Nicaraguan laws. Our Stock Exchange is still rather small, as is the process of modernisation. There are only a few local companies registered in the Stock Exchange. Most securities traded at the Exchange are debt titles issued by local banks or public institutions.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

There are many provisions that can be negotiated in this kind of transaction, such as representations and warranties, indemnities, enhanced due diligence regarding anti-money laundering provisions, etc.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

On the sell-side, it is usually preferred that a fixed price is determined in the purchase agreement. On the buy-side, some parties try to negotiate price adjustment clauses that allow for some variations depending upon certain events or financial results that may occur between the time of execution of the agreement and the effective time of closing.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

Typical warranties would refer to incorporation of the company, sufficient authority to enter into the transaction, current licences to operate and other business matters. However, sellers usually limit the scope of their representations.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

If there are undisclosed liabilities during the due diligence process, indemnities may be granted to cover them. Other covenants may include non-compete and non-solicitation provisions for terms of one to three years.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Local insurance companies do not typically offer this kind of policy. Foreign policies may be contracted instead.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

This will depend on the specific negotiations among the parties. It is common to find provisions that establish a threshold for indemnities (minimum amount subject to indemnification); baskets for cumulative claims and caps (limits for overall liability). Time limits are often established for seller's liability (one to two-year term). Specific areas such as labour and tax are subject to statute of limitation provisions.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

It is not common for PE sellers to provide security to respond to warranties and liabilities. It is more common a practice to negotiate escrow accounts with third parties or have holdback on the purchase price to secure such events.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

The PE fund usually is responsible for the funding of the transaction

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with its own capital or with bank financing. A condition for closing is having evidence of payment of the purchase price. Representations and warranties would include a provision regarding the stats of the financing and/or availability of funds to secure the transaction. In some transactions a guarantee of the holding company of the acquiring entity is also requested.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are not common in Nicaragua. In case of default termination of the agreement, damages can be claimed (usually under foreign law and foreign courts).

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

If a seller goes public at the time of selling the company the costs of the transaction and timing may be significantly higher than in a private transaction. The company will need to register before the Stock Exchange and the Superintendence of Banks. Legal and financial information will need to be facilitated, a brokerage firm will need to be hired, commissions will have to be paid, and so forth. Before going public the company will need to comply with all the listing regulations (financial statements, governance, AML provisions, etc.). The Nicaraguan market is very small and this process will require a particular effort on the seller side.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

This kind of transaction is not common in our market so there are no customary lock-up periods.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Dual-track processes are not common in our market.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

PE transactions are usually financed through bank-led loans in leveraged buyouts. These may be whole-sum loans or revolving credit facilities.

Given the socio-political crisis that began on April 2018 in Nicaragua, the local finance market has decreased. However, it is not uncommon for PE investors to finance their acquisitions through bank-led loans provided by off-shore financial institutions. Similarly, high-yield bonds operations are usually held in other jurisdictions to raise enough capital to acquire a Nicaraguan company.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

There are no general limitations or requirements that condition the structure of debt financing of PE transactions in Nicaragua. The structure of the debt financing will largely depend on tax considerations.

It is worth noting, however, that Nicaraguan financial institutions may not acquire shares of the entities that they finance.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

The socio-political crisis that began in Nicaragua in April 2018 has negatively affected the debt financing market as local financial institutions have not been granting credit to local investors. Furthermore, the cost of financing in Nicaragua has risen due to the increased country risk.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

PE investors are not considered taxpayers for income tax purposes.

In Nicaragua, the territorial principle applies for income tax. According to the tax law, income tax will be applied to income accrued or received from a Nicaraguan source, obtained in Nicaraguan territory or that comes from their economic relations with other jurisdictions.

Nicaraguan source revenues are those derived from goods, services, assets, rights and any other type of activity in the Nicaraguan territory, even when those incomes accrue or are received abroad, whether or not the taxpayer had a physical presence in the country.

In case of payments made by a Nicaraguan company to a non-resident for rendering services to a local company, the same will be subject to a withholding tax with a rate of 20%.

In Nicaragua, there are no double taxation treaties.

Off-shore structures are common in PE transactions in Nicaragua.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

The most common arrangements for tax-efficient purposes are stock purchase plans (stock options) deferred in time.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

For income tax purposes, capital gains tax applies over the gains in share and asset transfers. Capital gains would be equivalent to the

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difference between the book value of the shares (equity) or assets and the transfer price or market value.

The capital gain withholding tax rate is 15% for non-residents.

For tax purposes, the transfer price of a share and/or asset transfer between unrelated parties cannot be different from the market value.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

Recently, the Nicaragua government approved tax reforms which entered into force on February 28, 2019. Tax reforms include:

1. Tax collection plan by tax administration.
   - 1.1. Increased tax rate on minimum payment advance applicable as income tax.
   - 1.2. Increased capital income and capital gains rates.
   - 1.3. Increase on withholding tax for non-residents (individual and entities).
   - 1.4. Increased taxes applicable by industries.
2. New timing and deadlines to submit taxes and forms.
3. New regulations on transfer pricing using the method of non-regulated comparable prices.
4. New regulations for exemptions and exonerations of VAT.
5. Amendments to other laws that have tax regulations.
6. Establishment of new attributions for tax authorities:
   - 6.1. Extension of attributions in the scope of the determination of tax obligation. In that regard, the authority may: (i) request filing new statements; or (ii) request correction of the submitted filings.
   - 6.2. The timing to calculate terms to notify the determinative resolutions has been clarified and specified.
   - 6.3. Regulate the transfer pricing method through administrative or technical disposal.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

In Nicaragua, PE transactions are governed by the Nicaraguan Code of Commerce, the Nicaraguan Civil Code and party autonomy principles.

The capital markets law specifically regulates investment funds that raise capital through a public tender offer. However, foreign investment funds, which are the most common types of investment funds operating in Nicaragua, are not subject to this law. Hence, there are no significant and/or regulatory developments that may impact PE investors or other types of transactions.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

Since most PE investors are typically foreign, there has been little to no regulatory scrutiny regarding PE transactions that take place in Nicaragua.

Financial institutions and other obliged subjects, according to AML provisions, may perform KYC procedure to the PE investors investing in Nicaragua, if and only if, the services of these types of entities are required.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

Scrupulous legal due diligence is conducted by PE investors prior to any acquisition. However, timeframes, materiality, scope and other aspects of the due diligence may vary on a case-by-case basis. These variations depend on the size of the target, the industry involved and the specific regulations affecting it if it is a regulated entity.

Moreover, the place of origin of the PE investors also affects the legal due diligence since some countries have higher standards for their PE investors to acquire off-shore entities in Nicaragua.

The entry of certain specific Nicaraguan persons and entities to the designated US OFAC list has placed a higher level of scrutiny for all US Persons involved in a PE transaction in Nicaragua.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Local anti-bribery and anti-corruption legislation have little to no effect on PE transactions. However, compliance with foreign anti-bribery and anti-corruption legislation such as the Foreign Corrupt Practices Act (FCPA) is given priority in PE transactions. On the other hand, if the target company is subject to AML provisions a special compliance diligence will need to be performed.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

The rules of limitation of liability for shareholders in companies protect PE investors in most cases. However, this limitation may be ineffective in cases of fraud or in abuse of such limitation. Hidden liabilities of the target may affect the PE investor. That is why complete due diligence is recommended to try to identify and mitigate those risks with proper measures (indemnity provisions, price adjustments clauses, escrow accounts, etc.).

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

In Nicaragua, many public registries are still manual, not automated. This might require more time for investigation regarding real estate, corporate, litigation and other relevant aspects of a due diligence process.

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Nigeria

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

Growth capital, venture capital, buyouts and mezzanine finance are common in Nigeria, achieved via share subscriptions and transfers, and quasi-equity instruments and debt. Following recent elections and its emergence from a "technical recession" deriving from various macroeconomic challenges including FX and oil price volatility, the Nigerian market is relatively resilient and increasingly diversified, with the overall outlook for 2019 remaining positive. Industry analysts report increased utilisation of convertible and equity-linked notes, mezzanine finance and alternative capital structures. PE deal activity continues to be strong in consumer goods, financial services, energy, mining and utilities, TMT, business services, pharma, medical and biotech, construction, industrials and chemicals and transportation.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Large population, young consumer demographics, cheap and relatively educated labour force, competitive company valuations, sectoral restructuring and evolving policies aimed at enabling business in Nigeria are helping to boost PE activity and Nigeria's ease of doing business rankings. The Central Bank of Nigeria (CBN)'s introduction of an investors' and exporters' FX window enables FX trading at market-determined rates, which boosts FX availability. Repatriation of proceeds from investments in Nigeria remains a relatively straightforward process.

Analysts and dealmakers identify macroeconomic challenges, underdeveloped capital markets and infrastructure, red tape and bureaucracy, challenges with navigating the existing legal and regulatory framework (much of which is not PE-specific) and local content requirements, among other reasons, as PE-activity inhibitors. Macroeconomic challenges have been historically cyclical, and do not appear to permanently inhibit PE transaction activity in Nigeria in the medium to long term.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

The Federal Competition and Consumer Protection Act (FCCPA) was signed into law on 30 January 2019 and repeals the Consumer Protection Act and the merger control provisions of the Investment and Securities Act (ISA). The FCCPA also establishes the Federal Competition and Consumer Protection Commission (FCCPC), which is vested with powers to approve and regulate mergers (including amalgamations, business combinations and joint ventures), assuming a role that hitherto had been performed by the Securities and Exchange Commission (SEC). In transactions involving public companies, the SEC will continue to act as securities regulator with oversight over such transactions. This development will mean greater regulatory scrutiny for PE transactions from a competition perspective.

Notably, the FCCPA applies to "all undertakings and all commercial activities within or having effect within Nigeria" as well as offshore transactions that result in a change of control of "a business, part of a business or any asset of a business in Nigeria" the approval of the FCCPC will be required for such transactions.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Bilateral majority acquisitions and minority acquisitions of shares in Nigerian target companies are most common, often implemented by Investor-controlled offshore-registered special purpose vehicles (SPVs).

2.2 What are the main drivers for these acquisition structures?

Control and direct influence are the main drivers for such acquisition structures. Majority acquisition structures confer these attributes under applicable legislation while acquirers of minority stakes seek contractual and similar protections such as key executive appointments to provide insight into financials, operations, etc. Other drivers include risk mitigation or diversification, flexibility, exit considerations, maximisation of returns and tax efficiency (share transfers are exempt from capital gains tax (CGT) and governance

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considerations. The Companies and Allied Matters Act 1990 requires foreign companies intending to "do business" in Nigeria to do so through Nigerian-incorporated entities.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

Target equity structure will usually reflect capital contributions. Shareholders and management may participate through an investment company, with management interest being, typically, circa 5%. Carried interest is typically structured through a separate vehicle: an offshore limited partnership vehicle with equity in an offshore holding company (BuyCo) on an agreed percentage-split basis.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Minority protection structures will aim to facilitate and support voting arrangements, information and access rights, board and board committee participation and nomination rights in relation to key executives and board members, including board chairpersons, with the ultimate objective of attaining control and influence. Such strategies may be required to be entrenched contractually and in constitutional documents by minority investors as a transaction conditions precedent.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Typically, 5%–10%. Transaction documents may include "good leaver" and "bad leaver" provisions that determine compulsory acquisition/pricing for employee-held shares. Vesting provisions may determine equity allocations conditional upon length of service and achievement of performance milestones.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Transaction documents typically envisage "good leavers" (e.g. management employees whose employment is terminated by retirement, death or disability) and bad leavers (e.g. management employees terminated for fraud).

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

Governance arrangements typically confer protection or augment investor control and may involve quorum prescriptions, reserved matters, board and board committee participation, consultation and participation in executive recruitments, voting agreements and veto rights, organisational and operational structures and related issues entrenched in target company constitutional documents and/or shareholder agreements. The latter are generally confidential but may be replicated in target constitutional documents that are required to be publicly filed at the Corporate Affairs Commission (CAC). In listed targets, information that could materially affect a target's share price (including shareholders' agreement with the target as a counterparty) may be required to be publicly disclosed.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

The Companies and Allied Matters Act (CAMA) prescribes minimum thresholds for specified decisions as ordinary resolutions (50%+1 vote) and for special resolutions (75%), and board decisions via majority. Investors acquiring minority stakes typically negotiate supermajority and veto rights for specified "reserved matters" such as acquisitions, disposals, business plans, related party transactions, debt arrangements, executive appointments, exits, share capital changes, board composition, significant expenditures, amendments to constitutional documents, winding up and other matters subject to CAMA mandatory prescriptions.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

Mandatory provisions of the CAMA, such as voting thresholds for the removal of a director, will override any conflicting arrangements in shareholder contracts and constitutional documents, rendering such arrangements unenforceable. Director nominees have fiduciary obligations and may not fetter their discretion to vote in any manner.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

PE investors are bound by mandatory provisions of laws such as the CAMA, the ISA (as well as regulations issued by the SEC pursuant to the ISA (SEC Rules)) and constitutional documents protecting minority shareholders. For instance, the ISA and SEC Rules require investments in public companies above the 30% threshold to trigger the requirement to make a tender offer to minorities where the 30% interest (a) is proposed to be acquired in the course of a single transaction, or (b) has been acquired in a series of transactions over a period of time, except where exemptions apply.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Shareholders' agreements are subject to mandatory provisions of the law including the CAMA, and to a target's constitutional documents.

Nigerian courts will generally uphold a choice of foreign law. The Supreme Court has affirmed that a "real, genuine, *bona fide* and reasonable" choice of law (other than Nigerian law) that has "some

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relationship to and (is) … connected with the realities of the contract considered as a whole" will generally be upheld, subject to limited exceptions. Non-compete clauses and non-solicitation clauses are subject to negotiation but must be reasonable in order to be enforced. Non-compete provisions will also be subject to the FCCPA which prohibits agreements in restraint of competition and agreements with undertakings containing exclusionary provisions.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

See question 3.3. The CAMA imposes director qualifications and restrictions, including that they must not be fraudulent, convicted by a High Court of any offence connected with the promotion, formation or management of a company, or be bankrupt or mentally unsound. Sectoral qualifications may also apply (for instance, the CBN prescribes specific qualifications for bank directors). Directors may incur personal liability for, e.g. loss or damage sustained by a third party as a result of untrue statements or misstatements in a public company prospectus, under the ISA. The termination of employment of an executive director does not result in his automatic removal from the board; involuntary removals of directors must follow a prescribed statutory process. Disclosure of (unpublished, price-sensitive) information by nominee directors may breach insider dealing provisions under the ISA and the SEC Rules.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

The CAMA requires that the personal interest of a director must not conflict with his duties as a director. A director may not, in the course of managing the affairs of the company, misuse corporate information in order to derive a benefit and is accountable to the company for any benefit so derived, even after he resigns from the company. Sitting on the board of more than one company concurrently does not excuse a director from such fiduciary duties to both, including a duty not to (mis)use property, opportunity or information. Actual or potential conflicts of interest are required to be disclosed to investee company boards for consideration. Subject to this, nominee directors may opt to recuse themselves from participation in certain decisions at board meetings, although this may not be mandatory.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

Transactions can be completed fairly quickly if they are not complex, involve experienced parties and advisers, and require no regulatory approvals. Delays may arise during external due diligence regulatory verifications (where reviews are entirely manual), in procuring regulatory approvals from, e.g. the FCCPC, the SEC and other sector-specific regulators, e.g. the CBN, the National Insurance Commission, and the Nigerian Stock Exchange (NSE), as applicable, and in capital raising.

4.2 Have there been any discernible trends in transaction terms over recent years?

Parties are increasingly creative in structuring equity, debt and alternative capital deal terms to diversify and mitigate risk exposure in response to economic and other challenges. Offshore transaction structures continue to provide PE investors with flexibility from a governance and fiscal perspective. Certain investors, in a bid to reduce FX volatility exposure, seek to include cancellation and early termination terms, which are usually rigorously negotiated.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

The ISA, SEC Rules, NSE Rulebook (for listed targets), and the mandatory Code of Corporate Governance apply to transactions involving public companies and impose disclosure and reporting requirements where such transactions exceed prescribed thresholds or, in listed companies, involve changes that could affect the target's share price. FCCPA approval and sector-specific reporting obligations may apply. PE investors and targets usually retain skilled professional advisers to ensure compliance with applicable requirements.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

Deal protection mechanisms adopted include structures that isolate identified liabilities following detailed due diligence, representations and warranties insurance, the use of escrow structures, the adoption of governance arrangements along the lines outlined above, and where negotiated, break fees (although this is not common).

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

Cash structures are typically preferred, although there have been a number of share swaps and structures incorporating earn-out arrangements.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

This is subject to negotiation. Exiting PE sellers will typically seek to give minimal warranties (restricted to title and capacity). Where a PE sponsor and the target's founder(s) exit at the same time, comprehensive warranties and indemnities may be required by the buyer.

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6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

While this is subject to negotiation, PE sellers do not typically offer a comprehensive suite of undertakings beyond those indicated at question 6.2 and will typically resist restrictions on their activities post-exit.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

This is increasingly popular. Investors may resist requirements to mandatorily procure such insurance to reduce or exclude counterparty(ies) liability. The cost of such insurance may depend on risk appetite and the extent of the perceived exposure.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

This is subject to contractual negotiation. There is no standard practice other than as may be mandatorily prescribed by statutory and Common Law limitations on liability.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Please see question 6.2. This is subject to negotiation and may be subject to the expiration of the fund/SPV in an exit scenario. Escrow arrangements for up to two years are not unusual. Consideration may be disbursed in tranches subject to investor-prescribed performance milestones.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Evidence of funding in the PE investor's designated account, and of acquisition funds held in an escrow account and concomitant arrangements for disbursement subject to specific conditions being met, are means via which such comfort may be provided. Please see question 6.6 above. Such evidence may not be required where the buyer is of good reputation and standing, in which case an equity commitment letter addressed to both the target company and the seller may suffice, backed by an appropriate financial capacity warranty. Seller enforcement terms are subject to negation and may confer remedies of specific performance and damages for buyer non-compliance.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are not prevalent but may be negotiated on a case-by-case basis.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

A PE seller should be aware of the cost of effecting the IPO, the value of the seller's shares following changes in share capital, and the underwriting of shares not taken up by/issued to third parties. Material agreements with a potential impact on share price may have to be disclosed.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

This is subject to negotiation and there may be a restriction for a prescribed minimum of years post-investment. PE sellers will usually seek to avoid or minimise such requirements.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

This is not uncommon. The macroeconomic environment, capital market illiquidity, dearth of trade buyers, share valuation on exit, timing and regulated process challenges may require flexibility in the path to exit.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Convertible and non-convertible loans and alternative debt structures, credit support instruments, and investments in relative high-yield instruments including treasury bills and bonds, are not uncommon.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

Nigerian law guarantees free remissibility of dividends, profits, capital on divestment and repayments of principal and interest on foreign loans utilising the official FX market, subject only to a certificate of capital importation having been obtained from a CBN-

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authorised dealer bank when the original investment or loan capital was inflowed into Nigeria.

Investors also have access to the interbank market for such eligible transactions, meaning that PE and other investors can convert capital brought into Nigeria for investments into Naira at a (mostly) market-determined exchange rate, as applicable rates are no longer fixed by the CBN.

Financial assistance by Nigerian targets is generally prohibited where there would be a resulting impact on the net asset value of the target above prescribed thresholds. There are currently no thin capitalisation rules in Nigeria; targets are not generally restricted by any debt-to-equity ratio unless specifically prescribed by constitutional documents. Transfer pricing restrictions apply to related party transactions, which must be at arm's length.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

There has been an increase in debt financing through development finance institutions (DFIs) and syndicated loans in which DFIs invest in Nigerian sub-nationals to boost growth in emerging companies.

The introduction of the electronic certificate of capital importation (e-CCI) has also made it easier to process transactions as well as ease the tracking process for such transactions.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Key tax considerations for PE investors and transactions in Nigeria include:

(a) an analysis of the nature of the investment and the vehicle through which the investment will be made;

(b) applicable taxes at the time of making the investment and on exit (including stamp duty and filing fees on transaction and security documents where applicable);

(c) applicable taxes on income derived from the investment (e.g. withholding tax on dividends, interest on loan and management fees, etc.);

(d) applicable rate of corporate tax and other related taxes;

(e) applicable transfer pricing regulations (for shareholder loans/related party transactions); and

(f) tax incentives (e.g. 2.5% deduction on withholding tax on dividends, interest and royalties for investors resident in countries with which Nigeria has a double tax agreement (DTA)), and exemptions (e.g. % depending on the tenor of the loan, including a moratorium and grace period). It is becoming increasingly common for BuyCo's residents in countries with which Nigeria has Double Tax Treaties to be utilised for Nigerian PE investments and debt finance transactions.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Utilisation of SPVs incorporated in jurisdictions with which Nigeria has DTAs to reduce withholding tax on dividends; granting of long tenured loans of up to seven years and above to achieve 0% withholding tax on interest; use of share sale structures that are CGT-exempt.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

Share sales are CGT-exempt even where the proceeds from one sale are rolled over into a new share acquisition. Gains realised from asset disposals are not, however, so exempt where the buyer is not related to the seller. Proceeds from asset sales used to acquire other assets for the same business are entitled to roll over relief, i.e. no CGT. Where the asset rollover is between related entities, investors may avoid CGT if they obtain clearance and direction from Nigerian tax authorities which will, however, usually require that such transfer must be at the tax written down value of the assets.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

There have been no significant changes in tax legislation or the practices of the Nigerian tax authorities which specifically affect PE investment in Nigeria in the last year.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

On 17 January 2019, the House of Representatives passed the Companies and Allied Matters Act (Repeal and Re-Enactment) Bill (Bill), which had previously been passed by the Senate on 15 May 2018 and contains notable company law innovations. The Bill remains subject to Presidential assent which is pending. If passed in its current form, the Bill will make it possible for limited partnerships (LPs) and limited liability partnerships (LLPs), which are structures usually adopted by PE funds, to be recognised and registered within the framework of this federal legislation. Currently, only Lagos State provided a legal framework for LPs and LLPs, and the constitutionality of that framework has been debated.

The Income Tax (Transfer Pricing) Regulations 2018 (Regulations) were introduced by the Federal Inland Revenue Service on 12 March 2018 to regulate transactions between related parties and ensure compliance with the "arm's-length" principle. In relation to intra-group services, specific benefits and shareholder activity tests are required to be administered in addition to a price assessment to determine the arm's-length nature of intra-group charges.

Please also refer to question 1.3 in relation to the enactment of the FCCPA and establishment of the FCCPC.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

Nigerian law permits 100% foreign ownership of Nigerian

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businesses other than in certain sectors such as shipping, broadcasting, advertising, private security, aviation and oil and gas. Nigerians and foreign nationals cannot invest in the production of: arms and ammunition; narcotic drugs and psychotropic substances; or military and paramilitary wear and accoutrements.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

This is subject to negotiation and investors' objectives, budgets and timelines. The scope of the inquiry, materiality and timelines may be subject to counterparty negotiation. Typically, legal due diligence will cover the corporate structure, regulatory compliance, employee-related liabilities, material contracts and debt portfolio, intellectual property and the litigation profile of the target. The typical timeframe for a detailed review can be four to six weeks, subject to factors such as availability and quality of information provided by targets and held in public registries and courts, where searches remain largely manual.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Anti-bribery and corruption (ABC) and anti-money laundering (AML) requirements under legislation and international treaties and agreements are generally prevalent in PE funds, fund structuring, fund management and transaction arrangements in Nigeria.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Shareholder liability is generally limited to the amount (if any) unpaid in respect of any shares held by the investor in a Nigerian limited liability company. Please also see question 3.6 on the potential liability of nominee directors.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

A factor to consider is the strategic importance of choosing partners aligned with the PE investor's outlook and objectives of: compliance and ESG arrangements; having a pragmatic and realistic approach to regulatory interactions and timelines; and working with experienced local advisers.

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Christine Sijuwade is a Managing Associate and a core member of the team that advises several local and international private equity firms in connection with the structuring and establishment of their funds as well as their equity investments in various Nigerian companies including companies in the telecommunications, financial services, food and beverage, healthcare and manufacturing sectors. She has also advised on international lending transactions including syndicated loans and has been involved in a diverse range of financial and capital markets transactions including private placements and, as part of her Asset Management and Collective Investment practice, the establishment of mutual funds. She also advises on issues relating to the Nigerian bond market. As part of her corporate advisory practice, Christine supervises due diligence reviews, in the course of which she evaluates regulatory compliance practices and credit portfolios to assess the viability of targeted businesses for merger, investment and financing transactions.

Udo Udoma & Belo-Osagie is a full-service commercial law firm headquartered in Lagos, Nigeria. Its private equity team advises funds, managers, institutional investors, financiers and targets on structuring, tax, investment and compliance and is committed to regulatory advocacy initiatives for private equity. The firm participates on the legal and regulatory committees of the African Venture Capital Association and the Emerging Markets Private Equity Association (EMPEA) and is a founding and board member of the Private Equity and Venture Capital Association of Nigeria. All three private equity partners are recognised in international independent rankings publications including *Chambers Global*, *The Legal 500*, the *IFLR1000* and *Who's Who Legal* (Nigeria), and are commended in *The Lawyer's* 'Africa Elite' Private Equity Report.

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Norway

Aabø-Evensen & Co

Ole Kristian Aabø-Evensen

1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

Although the Norwegian private equity ("**PE**") market ranges from seed and growth investments by angel and venture capital funds, to leveraged buyouts ("**LBO**") and secondary transactions by PE funds (herewith public-to-private acquisitions and IPO exits); in 2018, LBO transactions of private targets dominated the transaction volume, representing 60.8% of the total PE transactional volume for that year.

In 2018, the total Norwegian M&A-market experienced a decline in volume and total reported deal value compared with 2017, and so did the Norwegian PE market with a 9.7% decline in reported volume compared with 2017. For deals involving PE Sponsors in 2018, (either on the buy- or sell-side) the average reported deal sizes also took a significant dive from €567 in 2017 to €249 in 2018. The market continued to be driven by new investments and add-ons, but in 2018 we witnessed a decrease in the number of exits and a slight increase in the number of new investments.

As mentioned above, the Norwegian PE market spans the width of all transaction types found in any mature market, but the typical *club deals* have, save for a few exceptions, for all practical purposes been outside the realm of the Norwegian PE market. The main reason for this is that most Norwegian transactions are of a size that normally does not require a major international PE fund to spread its equity risk in order to avoid exceeding investment concentration limits in its fund. The foregoing notwithstanding, sell-downs or syndication of minority equity portions subsequent to buyouts also occur in the Norwegian market.

Deals related to the oil, gas and supply industry have traditionally dominated the Norwegian PE market. In 2018, the oil and gas segment became more volatile than in 2017; PE funds also continued to show interest in this sector in 2018, but much less than for 2017. However, by share number of PE transactions, TMT, the Services and the Consumer sectors dominated the Norwegian market in 2018, each with 31.5%, 17.8% and 16.4% of the buyout investment volume respectively, followed by the Industrial & Manufacturing Sector and the Energy Sector, each with 13.7% and 9.6% of the total deal count respectively.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

The most significant features encouraging PE actors to transact in Norway are access to relatively inexpensive capital as well as a highly educated workforce, innovative technology, natural resources and a well-established legal framework for M&A transactions. In respect of the latter (see further in section 3), those familiar with M&A transactions and methodology in most other parts of Europe will find the Norwegian landscape quite familiar, both in respect of private and public acquisitions. Most EU-regulations pertaining to M&A transactions have also been implemented in Norwegian law through membership in the European Free Trade Association ("**EFTA**") and the European Economic Area ("**EEA**").

Historically, an important factor, viewed by many investors as sheltering Norway against international financial turmoil, has been a high oil price. The decline in oil prices witnessed at the end of 2014 and throughout 2016 was, in this aspect, serious, but never dissuaded PE actors from transacting in Norway. Declining oil prices in combination with a somewhat aggressive approach by Norwegian tax authorities against LBOs (herewith principles of PE funds domiciled in Norway) could in the long term potentially frustrate international PE funds' appetites for Norwegian targets, but given all the positive counterweights combined with improved oil prices witnessed over the last couple of years, we do not see this as a likely scenario, at least not in the very near future.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

We anticipate that, in *relative* terms, we may see a slight decrease in more traditional buyout transactions compared to a slight increase in other approaches, such as buy-and-build strategies and alternative investment structures, including minority stakes, corporate control transactions, club deals (including PE and trade combinations) and growth investments. This trend has been observed in other jurisdictions for some time, and currently we've already started seeing a few Norwegian funds applying some of these strategies in Norway. We expect that this trend will continue in the years to come since many funds wants to move away from the auction races that are typical for the more traditional buyout transactions.

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2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction? Have new structures increasingly developed (e.g. minority investments)?

Virtually all national and international PE funds are today organised as some type of limited partnership, wherein the institutional investors participate as direct or (normally) indirect limited partners, and wherein the fund manager (in the following the "**Manager**" or the "**Sponsor**") acts as the general partner, normally owned through a private limited liability company ("**LLC**") specifically organised for this purpose. The domicile, tax status and internal structure of the Manager sponsoring the fund will very often drive the choice of the general partner.

PE funds typically create a special purpose shell acquisition vehicle ("**SPV**") to effect an investment or acquisition, and commit to fund a specified amount of equity to the SPV at closing. The final acquisition structure adopted by these PE funds in the Norwegian market will normally depend on whether the respective fund is organised under Norwegian law or under foreign jurisdictions. Funds organised under Norwegian law will, when investing into Norwegian target companies, normally adopt a one-tier structure by investing through a set of Norwegian holding companies.

Funds organised under a foreign jurisdiction investing into Norwegian target companies will usually structure the acquisition by adopting a two-tier structure, irrespective of whether the Manager is foreign or domestic. **Firstly**, the PE fund establishes an offshore holding structure of one or more private LLCs incorporated and tax resident outside of Norway – typically in Luxembourg, the Netherlands or (occasionally) Cyprus. **Secondly**, the acquisition of the shares in the Norwegian target company will be made by the foreign holding structure through a Norwegian incorporated and tax resident special purpose vehicle (an SPV or "**BidCo**") that eventually acquires the target company. Additional Norwegian holding companies could be added into the structure between the foreign holding structure and the Norwegian BidCo to allow for flexibility in obtaining subordinated debt financing and other commercial reasons.

Occasionally over the last three years, we have also seen examples of Sponsors carrying out minority investments in listed companies, but these funds' limited partners have often criticised such strategies.

2.2 What are the main drivers for these acquisition structures?

Various deal-specific considerations dictate the type and organisation of the SPV, including, among others, tax structuring issues, desired governance structure, number of equity holders, equity holders' (and the Sponsor's) exposure to liability by use of the applicable vehicles, general ease of administration and required regulatory requirements including the financing bank's demand for structural subordination (see below).

Typically, the entry-route used by PE funds for their investments depends upon which structure provides the greatest flexibility for efficiently repatriating funds back to the fund's investor-base in connection with either an exit or a partial exit, with as little tax leakage as possible (i.e. minimising the effective tax rate for all relevant stakeholders upon exit). The choice of entry-jurisdiction into Europe, therefore, normally depends on the identity and geography of the fund's investors, the tax treaty between the proposed European entry-jurisdiction and the home jurisdiction for the majority of the fund's investor-base and the tax treaties between the various other jurisdictions involved, including Norway. It is not uncommon that Sponsors structure the investment through various forms of sub-partnerships (or feeder-funds) set up in different jurisdictions in order to achieve the most optimal structure for their respective investors, all depending upon such investors' geographical location.

Another main driver when choosing relevant acquisition structures (and particularly the number of holding companies involved), is the structuring of the financing (i.e. the bank's demand for control of cash flow and debt subordination); see sections 8 and 9. Particularly in large transactions, it can be necessary to use various layers of financing from different stakeholders in order to be able to carry out the acquisition. The need for flexible financing structures is a commercial reason that often drives the number of holding companies between the foreign holding-structure and the Norwegian BidCo.

In both instances, PE funds must consider *upstream* issues (taxation of monies extracted from the top Norwegian holding company ("**TopCo**") to the foreign holding-structure) and *downstream* issues (taxation of monies extracted from BidCo up to TopCo, herewith monies flowing up from the target and its various subsidiaries).

Before deciding the final acquisition structure, Sponsors must consider numerous additional issues, typically including: tax issues relating to management and employee compensation; the target's and its group companies' debt service capability; regulatory requirements/restrictions (i.e. prohibition against financial assistance and debt-pushdowns, and the new anti-asset stripping rules, *cf.* question 10.2); rules on thin-capitalisation and deductibility of interests; withholding tax on shareholder debt and distributions; VAT; and corporate liability and disclosure issues, etc.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

The equity structure in any PE transaction usually provides an opportunity and/or a requirement for the target's management to co-invest ("**Investing Management**") together with the PE fund in the acquiring group. The co-investment typically takes place at the Norwegian TopCo-level, or at the foreign holding company level. The equity strip for the Investing Management depends on the size of the transaction, but it is normally relatively small with a share price at an affordable level.

If the Investing Management mainly consists of Norwegian citizens, these may prefer to structure their co-investment into the Norwegian TopCo instead of into the foreign holding company structure. However, the PE fund may insist that the Investing Management must invest in the foreign holding-structure. From a valuation perspective, it is imperative for both the PE fund and the Investing Management that the Investing Management's equity participation is acquired at "full and fair market value", as participation under Norwegian law otherwise may be subject to income tax (rather than tax on capital gains). In order to achieve that the Investing Management invests at the same price per shares as the institutional investors, the Sponsor will typically invest in a combination of shareholder loans, preferred shares and ordinary shares, while the Investing Management mainly invests in ordinary shares (i.e. shares with no preferential rights). The Investing Management's senior members may occasionally also be allowed to invest in the same instruments (or "institutional strip") as the Sponsor. The detailed

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structuring of the management incentive package will depend on the tax treatment of any benefit. If the Investing Management pays less than the market value of the shares this could, under Norwegian law, give rise to an employment tax charge (46.6% marginal rate for the individual and 14.1% payroll tax for the employer).

In secondary buyouts, it is commonly a condition that the Investing Management must reinvest a proportion of their sale proceeds (rollover). Any gains on such rollover will, in principle, trigger capital gains tax for the Investing Management, unless the members of the management team invested through separate holding companies and these are those rolling over their investments. In recent years it has also become more common that the Investing Management invest into a separate pooling vehicle to simplify administration, which otherwise could be complicated by having a large number of shareholders (e.g. meeting attendance and exercising voting rights).

The carried interest arrangements (the "**Carry**") for Managers domiciled in Norway will more or less be the same irrespective of where the PE fund is located, although variations exist with regards to other key factors for how the profit from the fund's investments is split between the Manager and the Institutional Investors (such as annual fee, hurdle rate, catch-up, etc.). The Manager's right to Carry is almost always accompanied by an obligation to risk alongside the Institutional Investors, where the Manager as a precondition must risk its own money and invest into the fund's limited partnership. Today, such Carry arrangements may be structured using a separate limited partnership ("**SLP**") or offshore company, held directly or indirectly by the relevant investment professionals of the Manager, which in either case becomes a partner in the fund's limited partnership. Each participant's share of the Carry is delivered through an interest in the SLP, or in the fund itself by way of partial assignment of the offshore company's interest in the fund's limited partnership. In principle, distribution delivered this way should be the same for the Institutional Investors in the fund, namely a share of the income and gains derived from the underlying investments of the fund's limited partnership. As such, Carry has traditionally, under Norwegian law, been perceived as a regular return on investment and taxed as capital gains. Taxation of Carry has, however, become a much-debated topic in Norway in the last few years, where the Norwegian tax authorities have argued that the Carry should be taxed as income rather than capital gains. For taxation of Carry, see question 9.4.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

In such situations, a PE investor will focus on the exact same issues as mentioned in questions 2.2 above (particularly if they are using leverage to acquire their minority stake) and to find the right balance to align the various stakeholders' interests in creating value for its investors. The drivers behind equity terms and the equity structures are, normally the desires to control and incentivise, but the PE investor will likely obtain a lower level of protection when taking a minority position than taking a controlling stake. In addition, there will be particular focus on securing an exit route/timing of exit and securing anti-dilution rights/pre-emption rights on any issue of new shares.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Management offering to subscribe for shares in the acquiring group will typically be required to accept compulsory transfer of such shares if his/her employment terminates. The financial terms of such compulsory transfer depends on the reason for termination ("good" or "bad" leaver). If termination is due to acceptable reasons, typically death, disability or involuntary termination without cause, the person is a "good leaver" and will receive market value for the shares. If employment is terminated with cause, or if such person resigns without good reasons, the person is classified as a "bad leaver" and must sell the shares for less than market price.

Although subject to individual variations, neither time- nor performance-based vesting has been very common for the Investing Management's participation in Norwegian PE transactions, at least if the buyer is a domestic or Nordic PE fund. However, in transactions where international Sponsors are involved, vesting is more common. When introduced, a three to five-year time-based vesting model is often used, with accelerated vesting on exit. Such a vesting model means that only the vested part of the equity is redeemable at "fair value" at each anniversary ensuing investment, whereas the part of the equity that has not vested may only be redeemable at a lower value. Given the recent years' rather aggressive approach from the Norwegian tax authorities on Carry, some advisors fear that vesting provisions may be used as an argument for classifying profits from Investing Management's co-investments as personal income (in whole or in part) rather than capital gains. The obvious argument against such an assertion is that if the equity has been acquired or subscribed for at "fair market value" and at the same price per shares as the Institutional Investors (*cf*. question 2.3), then revenues therefrom should, strictly speaking, be treated and taxed in the same way as revenues derived from the institutional equity (i.e. classified as capital gains). Nevertheless, as there is no firm legal precedent on the matter, domestic PE funds seem to choose the path of least resistance by foregoing vesting. There is, of course, also a question in each transaction of how much "leverage" the PE fund has in relation to the Investing Management, and, correspondingly, how much push-back introducing vesting provisions will receive.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

"Good leaver" will usually mean leaving employment on grounds of retirement, death, disability or being discharged for "cause" not related to the employee him-/herself. "Bad leaver" will usually mean the employee him-/herself terminates his/her position prior to exit, leaving in circumstances justifying the summary dismissal of the employee (typically misconduct), or the employee being discharged for "cause" related to the employee him-/herself.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

The governance arrangements commonly used by PE funds to gain management control over their portfolio companies tend to be relatively detailed, but there could be substantial variations between domestic funds compared to the governance structure deployed by European or global PE funds.

The shareholders' agreement will normally contain provisions regarding corporate governance issues. The ability to appoint

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directors, and to control the board if necessary, is the key tool that the Sponsor will ensure is put in place in such agreements, including a right to appoint additional directors in order to flood the board in the event of disagreement with the executives and any employee representatives. Although some international funds also implement a separate management board, Norwegian portfolio companies normally only have a single board of directors on which the Sponsors are represented. It is not uncommon that some PE funds want to appoint an independent chairman to provide strategic oversight and to create an independent bridge between the Sponsor and the Investing Management. Through veto rights and/or preferential voting rights afforded in the shareholders' agreement, the Sponsor-appointed directors will usually have control over important decisions like new acquisitions and disposals, approval of business plans and annual budgets, new investments outside of the business plan, etc. Besides appointment/dismissal of directors (always subject to consent from the general meeting, meaning the Sponsor), the shareholders' agreement may further contain rules about audit and remuneration, business plans and budgets, transfer/issue of shares and financial instruments, confidentiality and other restrictive covenants, management of exit, and customary drag-, tag- and shot-out provisions. From a strict governance perspective, the important requirement for the Sponsor is to ensure that the shareholders' agreement provides the Sponsor with appropriate access to information about the company. There is no requirement for making such shareholders' agreements publicly available.

Unlike what is common in other jurisdictions (e.g. the UK or the US), it is not common to include a detailed set of protective provisions in Norwegian portfolio companies' articles of associations. Traditionally, most domestic PE funds have also preferred to keep these types of provisions only in the shareholders' agreements for confidentiality and flexibility reasons. For the last few years, it has nonetheless become more common to also include certain protective provisions in the articles, especially if the portfolio company is controlled by an international PE fund. Such articles must be registered in the Norwegian Register of Business Enterprises and are thus publicly available.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

The shareholders' agreement is normally drafted so that PE funds and their director nominees (through board majority or mandatory consent requirements) have control over the portfolio company and any important corporate action. This includes, *inter alia*: material changes in the nature of the business or disposal of any substantial part thereof; changes to issued share capital; major acquisitions; adoption of annual business plan/budget and recommendations in respect of dividend distributions; entering into any partnerships or creating any obligations, liens or charges; major employment matters like pensions and bonus schemes; and, naturally, entering into litigation or liquidation proceedings. Some Sponsors may divide the list of vetoes between those requiring director consent and those requiring Sponsor consent at shareholders' level.

A PE investor holding a minority position is likely to hold less protection than on taking a controlling stake. The priority areas will be ensuring that they have visibility of the day-to-day conduct of the business (i.e. board or observer seat), and ensuring that certain fundamental transactions which protect their ownership interest cannot be taken without their consent. Examples of such veto rights are: changes to the company's constitutional documents; disposal of key assets; borrowing of monies; and any form of debt restructuring transactions, etc.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

As a starting-point, shareholders can agree that one or more designated representatives shall have veto rights over certain decisions at the general meeting. Nevertheless, the traditional view is that a decision from the general meeting is valid regardless of whether some shareholders have voted in breach of contractual obligations under a shareholders' agreement. Consequently, to ensure that shareholders respect such veto rights, it is important that the shareholders' agreement contains appropriate enforcement mechanisms (see question 3.5).

Veto rights in a shareholders' agreement binds neither the board (as a governing body) nor the CEO. This means that even if a shareholders' agreement grants Sponsor-appointed directors to veto over certain important board resolutions, there is always the risk that the board disregards this and resolves the matter in question as the majority find appropriate. In order to cater for the "risks of disobedience", each director could be required to sign some form of adherence agreement to the shareholders' agreements, but if such adherence agreement is considered to bind the directors in their capacity as such (and not shareholders), there is a legal risk that the agreement, under Norwegian law, will be deemed invalid as constituting a fettering of their discretion (other valid portions of such agreements may remain in force). This risk cannot be eliminated by making the relevant company a party to the shareholders' agreement. The reason being that the board owes fiduciary duties to the company trumping those owed to a director's appointing shareholders. Therefore, the company cannot dictate how the board in the future shall exercise duties, discretions and judgments relating to individual matters put in front of them, unless otherwise set out in the company's articles. As a result, some funds seek to alleviate risk by implementing provisions in the portfolio companies' articles, stating that the shareholders and the company have entered into a shareholders' agreement regulating, *inter alia*, restrictions on transfer of shares, veto rights, etc. Such clauses will then state that the board may, as a condition for its consent to transfer shares, require that new shareholders accede to such shareholders' agreement. There is no clear court decision on the topic as to what extent such a reference in the articles will solve the problem, or if it is necessary to include the relevant text itself in the articles. In academic circles, the view is also divided.

If the directors are also shareholders in the company, it must be assumed that they are free to bind their powers in their capacity as shareholders. Consequently, Sponsors controlling sufficient votes in the general meeting can, in principle, seek comfort in their right to convene an extraordinary general meeting and remove disobedient directors from the board. Still, the right to remove board members cannot completely eliminate the risk that the portfolio company, as a result of the board's resolution, has already entered into a binding arrangement with a third party before a new board is elected. Normally, an appropriate and well-tailored enforcement mechanism in the shareholders' agreement itself will therefore, in most situations, be considered sufficient to ensure that no party (in particular the directors holding shares) has any incentive to breach the terms of the shareholders' agreement, and therefore that it will not be necessary with any further enforcement.

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In practice, most Norwegian funds seem to rely on such enforcement mechanisms in the shareholders' agreements instead of implementing lengthy articles. Having said this, over the last few years there seems to have been a move for implementing more detailed articles, in particular when UK or global funds are investing in Norwegian portfolio companies.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

The general principle under Norwegian law is that a controlling shareholder does not have any duty towards minority shareholders and is free to act in his or her own best interest unless otherwise is explicitly set out in law, the company's articles or in an agreement. Under the Norwegian Limited Liability Companies Acts ("**Companies Acts**"), however, a controlling influence cannot be exercised at board level, management level or at the general meeting in a manner likely to cause unjust enrichment to a shareholder or a third party at the cost of the *company* or another person. For PE investments in particular, the Sponsor will, in addition, have undertaken a set of detailed (but limited) undertakings towards minority shareholders (such as management shareholders), the main purpose being to align the minority shareholders' interest not through annual compensation, but through growing the business and receiving equity returns as shareholders.

Shareholders also have certain statutory minority protections through a detailed set of rules in the Companies Acts, including the right to attend and speak at general meetings, certain disclosure rights, rights to bring legal actions to void a corporate resolution on the basis of it being unlawfully adopted or otherwise in conflict with statute or the company's articles, etc. Some of these rights are granted to each individual shareholder irrespective of voting rights, and the Companies Acts also provides specific rights to minority shareholders representing a certain percentage of the share capital and/or votes.

Sometimes, Sponsors, particularly foreign Sponsors, may address certain of these statutory minority protection rules in the shareholders' agreement by introducing provisions that aim (directly or indirectly) to limit them. To what extent this is possible, and if so, how far and for how long it is possible to limit (or at least minimise) them, is subject to substantial legal uncertainty under Norwegian law. Many of the rules cannot be deviated from, and an overzealous shareholders' agreement could affect the validity of either the entire agreement or the particular provision in question (see question 3.5). By implementing several share classes with different financial and voting rights, and by introducing good leaver/bad leaver provisions, etc., a Sponsor may to some extent at least limit the financial impact of some of these minority protection rules so that the principles of the shareholders' agreement in general will apply. The same can be achieved by pooling the minority investors' investment in the portfolio company through a separate investment vehicle in which the Sponsor holds the controlling vote.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Insofar as the shareholders' agreement does not contravene statutory laws (e.g. the Companies Acts) or the relevant company's articles, such agreements are considered valid under Norwegian law, and can, in principle, be enforced among the parties thereto (but not against third parties). Even if the shareholders' agreement is binding, there are still some uncertainties as to what extent it can be enforced by injunctions. Nevertheless, it must be assumed that remedies other than injunctions agreed in such an agreement can be claimed before the courts.

In the event that a shareholders' agreement contains provisions that are conflicting with statutory minority protection rules or provisions in the company's articles of association, this could also result in the agreement not being enforceable, at least with regard to such provision (see question 3.4 above).

Further, note that if the shareholders' agreement attempts to bind the directors in their capacity as a director, there is a risk that this part of the agreement is invalid and cannot be enforced towards the company itself nor the director in question (see question 3.3). Also, note that it is not possible to extend the binding force of certain provisions of such an agreement by making the company itself a party to it (see question 3.3). Nevertheless, if the director is also a shareholder, and as such is a party to the shareholders' agreement, it must be assumed that such shareholders are free to bind their powers in the capacity of shareholders (see question 3.3). Provided appropriate remedies and enforcement mechanisms are agreed in the agreement itself, such mechanisms will therefore, in most situations, be considered effective towards such party.

Typically, shareholder agreements cannot be enforced towards third parties, but can be enforced against the party in breach. However, this may sometimes be of little help, unless the agreement itself contains appropriate and effective remedies and enforcement mechanisms (see question 3.3).

In terms of dispute resolution, the preferred avenue of approach for PE funds has, over the last decade, shifted from regular court hearings to arbitration, and it should be noted that alternative dispute resolution in general (including both arbitration and court-sponsored mediation) is now decidedly more common in Norway than in the rest of the Nordics. International influence combined with the perceived upsides (i.e. non-publicity, efficiency, expertise and costs) may be credited for this shift. Pursuant to the New York Convention, arbitral awards are enforceable in Norway. As from 1 January 2016, Norway implemented certain statutory limitations on the enforceability of non-compete clauses in employment contracts. Under certain special circumstances, the new rules may also have an impact on the enforceability of non-compete provisions of shareholder agreements.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies under corporate law and also more generally under other applicable laws (see section 10 below)?

Legal restrictions on nominating boards of portfolio companies

The CEO and at least half of the directors in Norwegian private and public LLCs must either be residents of Norway or EEA nationals who reside in an EEA state. With respect to this, at least half of the ordinary directors must fulfil the residential requirement; it will not suffice that solely deputy directors fulfil it, irrespective of how many of them are Norwegian residents or EEA nationals. The Norwegian Ministry of Trade and Industry may grant exemptions on a case-by-case basis. Also note that for public LLCs (irrespective of

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such companies being listed or not), Norwegian law dictates that each gender shall be represented on the board by (as a main rule) at least 40%. Consequently, on a board of five directors there cannot be fewer than two members of each gender. Exceptions apply to directors elected by and among the employees (if any).

PE funds must also take into consideration the requirements for employee representatives on Norwegian boards. According to law, employees are entitled to board representation, both in private and in public LLCs, provided the number of full-time employees in such a company exceeds 30. Under such circumstances, the employees are entitled to elect between one and up to one-third of the board members from among the employees. The exact number of employee board representatives varies with the number of employees in the company, but all employee representatives have the same voting rights as regular board members. Employee board representation is not mandatory under Norwegian law, but cannot be rejected if requested by the employees and the conditions for such representation are fulfilled.

Risks and potential liabilities for the directors appointed

Like other directors, a Sponsor-appointed director of a portfolio company owes fiduciary duties to the company that takes precedence over duties owed to the shareholders appointing him. Directors owe their duties to *all* the shareholders, not only the individual shareholder or group of shareholders nominating him/her. Upon assuming office, the nominated directors will be subject the same potential personal director liability as any other member. Under Norwegian law, directors or executive officers may become liable for damages suffered by the company, shareholders or third parties caused by negligence or wilful acts or omissions. In addition, directors can be held criminally liable as a result of intentional or negligent contravention of the Companies Acts and/or ancillary regulations. As a general principle, all directors (including employee-elected directors) are subject to the same standard of care or fault standard and, although the board acts collectively, a director's liability is personal. Joint and several liability only applies to such actions or omissions attributable to more than one board member.

Examples of potential risks and liabilities that Sponsor-appointed directors should be particularly aware of relate to the board's heightened scrutiny in controlling that all related-party transactions (if any) between a portfolio company, its shareholders and/or its directors are concluded at arm's-length basis. In a PE investment, such transactions may typically relate to fixing the interest rates on shareholder loans, and/or intra-group loans between the acquiring companies and the target group, or payment of various forms of management fees, etc. between such parties. Other forms of transactions falling within the same category may be transactions that directly or indirectly aim at distributing funds out of a portfolio company to the Sponsors or to third parties. Also, directors should be particularly aware of the general rule prohibiting a target company from providing upstream financial assistance in connection with the acquisition of shares in the target company (or its parent company). This prohibition against financial assistance has previously prevented Norwegian target companies from participating as co-borrower or guarantor of any acquisition financing facilities. Even though Norway has now implemented a new set of rules that somewhat eases the previous strict ban of financial assistance (by introducing a type of "whitewash" procedure), this is still an area that needs careful consideration and compliance with strict formalities if the respective directors shall stay out of peril. On a general note, it is also important to be aware that in order to be valid, related-party transactions must be approved by the general meeting if the consideration from the company represents a real value exceeding 10% (private companies) and 5% (public companies) of the share capital of the company. Note that additional formal requirements will apply for the approval process of such agreements. Certain exemptions from these requirements apply, typically agreements entered into as part of the company's normal business at market price and other terms that are customary for such agreements. Also note that several amendments for simplifying the Companies Acts were, *inter alia*, proposed in 2016 with regard to general meeting approval of such related-party transactions. However, for now, it is currently unclear when and whether these proposed changes will be implemented into Norwegian law (see question 11.1).

Directors violating any of the formal requirements described above may, at worst, expose him- or herself to personal responsibility/liability for ensuring that any funds/assets distributed in violation of such rules are returned to the company. Note that the new anti-asset stripping rules implemented by the AIFMD Act (see question 10.2) are also likely to result in personal liability for directors – in particular those appointed by the Sponsor if they contribute to the Sponsor's breaching of such anti-asset stripping provisions.

Further, note that in the event that a portfolio company is in financial distress, its directors will at some stage come under obligation to cease trading and file for court composition proceedings or to liquidate the company. Such distress situations very often involve some type of prior attempts of restructuring or reorganising the business to salvage the various stakeholders' financial interests. These types of attempts could involve selling off assets or parts of the business to a stakeholder against such stakeholder being willing to contribute additional cash or converting debt into equity, etc. It is not uncommon that such transactions, in the event that these attempts later fail, may be challenged by other creditors, the receiver or trustee on behalf of the creditors, and they therefore entail substantial risks of liability for the various directors.

Risks and potential liabilities for the Sponsors

In terms of liability, the general point is that a Sponsor itself will not assume or be exposed to any additional liability simply by virtue of nominating/appointing directors to a portfolio company. However, a parent company or a controlling shareholder may be held independently liable for its subsidiary's liability if it has contributed to a wrongful act through a controlling interest in the company. Consequently, if the Sponsor has reserved so many vetoes over the portfolio company that the management team is no longer able to carry out its day-to-day business in the ordinary course without first consulting the Sponsor, this could, at least theoretically, mean that the Sponsor might be considered a "shadow director" or manager of the business. Under these circumstances, consequent liability issues can arise for the Sponsor if something goes wrong. Having said this, to pierce the corporate veil under Norwegian law is not considered to be a particularly easy task.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

As mentioned in question 3.6, Sponsor-appointed directors are, upon assuming office, subject to the same corporate fiduciary duties as any other director on the board, and these rules (principles) cannot be departed from through shareholder agreements or constitutional documents.

According to law, a director in a Norwegian portfolio company is disqualified from participating in discussions or decisions on any

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issues that are of such personal importance to him, or any of his related parties, that the director is deemed to have a strong personal or special financial interest in the matter. The same will apply for a company's CEO. Whether or not this provision comes into play, demanding a director to step down while the remaining board resolves the matter, depends on an individual evaluation at any given crossroad. However, it must be assumed that most particular circumstances must be present – i.e. a director will not automatically be disqualified just because he is also director in another portfolio company that is the company's contractual counterpart. In a sense, it could be viewed as providing a safety valve for PE nominees that have a *personal financial interest* (by virtue of being a partner of the Manager and thereby entitled to parts of the Carry, *cf.* question 2.3) to withdraw from handling board matters (and thus avoiding any conflicts of interest) relating to other portfolio companies.

To avoid potential conflicts of interest arising between nominators and nominees, increasingly more PE-backed companies have introduced quite comprehensive instructions and procedural rules for both management (daily operations and administration) and the board of directors (board work and decision-making processes).

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

As a starting point, private corporate transactions do not require consent from Norwegian authorities, which means that regular share purchases can be completed in accordance with the timeframe agreed upon by the parties – i.e. there is no set timetable. Standard waiting periods pursuant to relevant competition legislation will apply, however. The major issues impacting the timetable for private transactions in Norway are:

- The initial diligence exercise that the buyer intends to undertake.
- Time necessary for financing discussions. The time required for such discussions will normally be heavily dependent upon the size of the deal and type of preferred financing options available. If it is necessary with bank financing syndications, mezzanine debt, issuing debt instruments, etc.
- In the event that it is necessary to file the transaction with domestic or foreign competition authorities, the time required to prepare the necessary disclosures to be submitted to such authorities. In the event of a change of control transaction, provided that the combined group turnover of the acquirer and the target in Norway is NOK 1 billion or more, and at least two of the undertakings concerned each have an annual turnover in Norway exceeding NOK 100 million, the transaction must be filed with the Norwegian Competition Authorities ("**NCA**"), unless filing takes place under the EU Merger Control Regime instead.
- If filing with competition authorities is necessary, the time necessary for such authorities' regulatory reviews, including requests for additional information from such authorities, and to wait for the expiry of standard waiting periods under such regulatory approval schemes. There is no deadline for filing a notification with the NCA, but a standstill obligation applies until the NCA has cleared the transaction. After receipt of the filing under the new rules, the NCA now has up to 25 working days to make its initial assessment of the proposed transaction.
- The necessity to comply with obligations to inform the employee union representatives and/or the employees of the transaction and its potential effects in accordance with law and relevant collective bargaining agreements.
- The time necessary for implementing relevant co-investment arrangements with Investing Management.
- The time necessary to establish the desired investment vehicles and special purpose vehicles in order to execute and complete the transaction.
- If the transaction is conducted through a statutory merger, where only private LLCs are involved, the merger plan with supporting documents will have to be made available to the shareholders no later than two weeks prior to the general meeting at which such merger will have to be decided upon. If public LLCs are involved in such a merger, the notice period is one month prior to the general meeting, and the merger plan must also be filed with the Register of Business Enterprises ("**RBE**") a month before the meeting. If approved by the general meeting, the merger must thereafter be filed with the RBE for public announcement; this applies to private and public LLCs alike. Once the announcement has been published by the RBE, a six-week creditor period begins, upon the expiry of which the merger may be effectuated.
- Also note that if the target company is operating within certain industries, there are sector-specific requirements to consider (such as requirements for public permits and approvals). These industries are banking, insurance, petroleum, hydropower and fisheries, etc., and the need for obtaining such public permits and approvals could heavily influence the transaction timetable.

Issues influencing the timetable for take-private transactions in Norway will in general be more or less the same. For such target companies, however, the following additional issues must be accounted for:

- The time necessary for the target's board to evaluate the initial proposal for the transaction and any alternatives.
- In a voluntary tender offer, the offer period must be no less than two weeks and no more than 10 weeks.
- In a subsequent mandatory offer, the period must be at least four weeks and no more than six weeks.
- The time necessary to conduct the squeeze-out of the minority shareholders.
- The application process for delisting the target in the event that the bidder has not managed to acquire more than 90% of the shares and some of the remaining shareholders file an objection against delisting the target company.

4.2 Have there been any discernible trends in transaction terms over recent years?

Structured sales (auction) processes continue to be the preferred option for PE exits in the Norwegian market – at least for transactions exceeding €100 million. Also, in smaller transactions the seller's financial advisors will often attempt to invite different prospective bidders to compete against each other. Conversely, a PE fund looking for an exit will never go for a bilateral sales process as a preferred exit route unless: (i) the fund has a very clear sense of who the most logical buyer is; (ii) an auction involves a high risk of damage from business disruption; and (iii) the PE fund feels it has a very strong negotiating position.

Throughout 2013 and at the beginning of 2014, confidence returned to the international equity capital markets. This again led to an upswing in the number of initial public offerings, both in the Norwegian market and the rest of Scandinavia. Due to this market

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sentiment, IPOs and "dual-track" processes became increasingly popular among PE funds looking to exit their portfolio investments, in particular for some of their largest portfolio companies where the buyer-universe might be limited and the relevant company needed to raise equity in order to pursue future growth strategies. In Norway, this trend continued through 2018 although transaction volume fell due to volatility in the market resulting from a declining oil and gas sector.

Stapled financing offers have again started to re-emerge in the Norwegian market, in particular for the larger deals in which the sellers are pursuing an exit via dual-track processes.

We have also seen increasing examples of sellers that, in order to accommodate a greater bidder universe, have been willing to offer certain attractive bidders some form of cost-coverage for money spent in an unsuccessful auction. These arrangements are subject to great variations, but, on a note of caution, they regularly include provisions that stealthily alleviate much of the apparent seller liability by prescribing that the buyer will not be entitled to any coverage if it is no longer willing to uphold a purchase price corresponding to the adjusted enterprise value of its initial offer.

Escrow structures as the basis for making contractual claims in respect of warranties and purchase price adjustments are not normally popular among sellers but, depending on the parties' relative bargaining positions, it is not uncommon for buyers to request escrow structures. In terms of new trends in the Norwegian PE market, there has been a significant uptick in the usage of M&A insurance (i.e. commercial insurance of warranties and indemnities in the sale and purchase agreement ("**SPA**")), which is also used to get rid of the aforementioned escrow mechanisms.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Takeover of a publicly listed company is subject to more regulation under Norwegian law than are takeovers of private companies. Both the prospective buyer and the targets' boards must observe a detailed set of rules and regulations, which among others comprises insider dealings rules, mandatory offer thresholds, disclosure obligations (regarding ownership of shares and other financial instruments), content limitations for offer documents, filing and regulatory approval of offer documents, length of offer periods, employee consultations, limitations on type of consideration offered, etc.

The main challenge in any acquisition, albeit more relevant to take-private of listed companies, is for the PE fund to secure a sufficient level of shareholder support (i.e. 90% or more of the target's shares and voting rights) in order to carry out a subsequent squeeze-out of any remaining minority shareholders. This 90% threshold is also important since it will be a straightforward process to have the target delisted from the Oslo Stock Exchange ("**OSE**") or Oslo Axess. If not, the process for delisting the target could be far more complex. In principle, there are several avenues of approach for PE houses desirous to taking a publicly listed company private under Norwegian law – one of which is to launch a voluntary tender offer to the shareholders. The principal legislation and rules regulating takeovers of publicly listed companies is found in Chapter 6 of the Norwegian Securities Trading Act ("**STA**"). One of the beneficial features with a voluntary offer is that, in general, there are no limitations in law as to what conditions such an offer may contain; this affords the PE fund a great deal of flexibility, e.g. with respect to price, type of consideration and required conditions precedents. A voluntary tender offer may be launched at the bidder's discretion, and the bidder can also choose to make the offer to only some of the shareholders. A voluntary offer can also be made subject to a financing condition, although this is rare.

A potential bidder will quite often find it challenging to successfully conclude a take-private transaction by launching a public bid without the co-operation and favourable recommendation of the target's board at some point in the process. The reason being that, as a rule, a bidder who launches a public tender offer for a listed Norwegian target does not have a right to be admitted to due diligence. This makes diligence access one of the bidder's main hurdles in a public takeover. The target is not restricted from facilitating a due diligence investigation by a bidder, but the scope and structure of such reviews in the context of a listed target will vary significantly. Provided that the target's board is prepared to recommend the offer, the bidder will normally be admitted to a confirmatory due diligence. It is therefore not surprising that a prospective acquirer (particularly PE funds) will almost always seek upfront recommendation from the target's board. In a control context, the prospective acquirer's first contact with the target is customarily a verbal, informal sounding-out (by the chairman or a senior executive of the acquirer or by the acquirer's external financial adviser) of the target's appetite for a take-private transaction. Depending on the outcome of that discussion, the fund will submit to the target a written, confidential, indicative and non-binding proposal and seek due diligence.

When the board of a listed company reviews a take-private proposal, it must uphold its fiduciary duties, which include two elements: a duty of care; and a duty of loyalty. The duty of care includes a duty for the board to inform itself, prior to making a business decision, of all material information that is reasonably available. Consequently, the directors must evaluate a proposed offer or business combination in the light of risks and benefits of the proposed transaction compared to other alternatives reasonably available to the corporation, including the alternative of continuing as an independent entity. It is currently not clear under Norwegian law to what extent this duty of care requires the board to reasonably inform itself of alternatives or actively seek alternative bidders in connection with a business combination transaction. Each director of a listed company considering a take-private transaction must also assess if, and to what extent, they can or should assist in the transaction, or if they have a conflict of interest. If a director in the target has a specific interest in a potential bidder, or in a bidder in competition of a first bidder, such director is incompetent and must not participate in the handling of issues relating to the bid.

Take-private transactions in Norway are subject to the same disclosure issues and requirements as other takeover offers involving a publicly listed company. The board of a listed target is, on an *ad hoc* basis and on its own initiative, required to disclose any information on new facts or occurrences of a precise nature that are likely to have a notable effect on the price of the target's shares or of related financial instruments (so-called insider information). This is an issue of particular concern for any bidder, as well as for a PE fund. The decision to engage in discussions with a PE fund relating to a potential take-private transaction and to divulge information is thus made at the discretion of the target's board. Confidential negotiations with the target's board at an initial stage are possible, with certain constraints, prior to the announcement of the bidder's intention to launch a bid, provided the parties are able to maintain confidentiality. However, the fact that a listed company is discussing a takeover or a merger (and the content of such

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negotiations) will at some point constitute inside information that must be disclosed to the market. The OSE's Appeals Committee has previously ruled that confidential negotiations between a potential bidder and the target's board could trigger disclosure requirements, even before there is a high probability of an offer being launched, provided that such conversations "must be assumed not to have an immaterial impact on the target's share price". Consequently, a potential bidder (like a PE fund) and the target's board must be prepared for a situation where the OSE takes the view that the requirement for disclosure is triggered at an early stage, possibly from the time the target enters into a non-disclosure agreement allowing due diligence access. The forgoing notwithstanding, if a target is approached regarding the potential intentions of launching a bid, this will in itself not trigger any disclosure requirements.

Under Norwegian law, a publicly listed target can take a more or less co-operative approach in a takeover situation. Confidentiality agreements between the bidder and the target, allowing the bidder access to due diligence or additional information about the target, will often include a "standstill" clause preventing the bidder for a specified period from acquiring stocks in the target without the target's consent. If the bidder obtains the target's support to recommend a "negotiated" tender offer, it is normal practice for the parties to enter into a detailed transaction agreement, which (typically) sets out the terms for the target's support and the main terms for the bidder's offer. Such transaction agreements also often include a non-solicitation clause granting the bidder some type of limited exclusivity, including a right to amend its offer and to announce a revised offer to match any alternative or superior competing offers that are put forward. The foregoing notwithstanding, the Norwegian Code of Practice for Corporate Governance ("**Code of Practice**") recommends that a target's board exercise great caution in agreeing to any form of exclusivity. The Code of Practice further requires the board to exercise particular care to comply with the requirements of equal treatment of shareholders, thus ensuring that it achieves the best possible bid terms for all the shareholders.

A PE fund may want to use several different tactics to ensure a successful take-private transaction, one of which is stake-building. Stake-building is the process of gradually purchasing shares in a public target in order to gain leverage and thereby increase the chances of a successful subsequent bid for the entire company (i.e. the remaining outstanding shares). Purchasing shares outside an offer may be prohibited if the bidder is in possession of insider information. In addition to the insider dealing rules, a bidder must pay particular attention to disclosure requirements during the stake-building process. The disclosure requirements are triggered by any person owning shares in a company whose securities are listed on a Norwegian regulated market (OSE or Oslo Axess), if their proportion of shares or rights to shares in such company reaches, exceeds or falls below any of the following thresholds: 5%; 10%; 15%; 20%; 25%; ⅓; 50%; ⅔; or 90% of the share capital, or a corresponding proportion of the votes, as a result of acquisition, disposal or other circumstances. If so, such person must immediately notify the company and the OSE. Breaches of the disclosure rules are fined, and such fines have grown larger over the years.

Except for the insider dealing rules, disclosure rules, and mandatory bid rules (see below) there are generally few restrictions governing stake-building. However, confidentiality agreements entered into between a potential bidder and the target can impose standstill obligations on a bidder, preventing acquisition of target shares outside the bidding process. Subject to such limitations, the fund can also attempt to enter into agreements with key shareholders to seek support for a possible upcoming bid. Such agreements can take various forms, from an SPA, a conditional purchase agreement, some form of letter of intent, MoU, etc., or a form of pre-acceptance of a potential bid. Pre-acceptances are typically drafted as either a "soft" or "hard" irrevocable ("**Irrevocable**") – the former normally only commits the shareholder who gives the Irrevocable to accept the offer if no higher competing bid is made, whereas the latter commits the shareholder to accept the offer regardless of whether a subsequent higher competing bid is put forward. It is assumed in Norwegian legal theory, that a properly drafted "soft" Irrevocable will not trigger the disclosure requirements. When dealing with shareholders directly in take-private transactions, a PE fund will also experience that shareholders are reluctant to grant extensive representations and warranties besides title to shares and the shares being unencumbered.

Another challenge in take-private transactions is that if a PE fund directly, indirectly or through consolidation of ownership (following a stake-building process or one or more voluntary offers) has acquired more than ⅓ of the votes in the target, it is (save for certain limited exceptions) obligated to make a mandatory offer for the remaining outstanding shares. After passing the initial ⅓ threshold, the fund's obligation to make a mandatory offer for the remaining shares is repeated when it passes (first) 40% and (then) 50% of the voting rights (consolidation rules apply). Please note that certain derivative arrangements (e.g. total return swaps) may be considered as controlling votes in relation to the mandatory offer rules. Of particular concern to PE funds, is that the share price offered in a mandatory offer cannot be lower than the highest price paid, or agreed to be paid, by the fund for shares (or rights to shares) in the target during the last six months. In special circumstances, the relevant takeover supervisory authority (i.e. the exchange where the securities are listed) may also demand that market price is paid for the shares (if this was higher at the time the mandatory offer obligation was triggered). A mandatory offer must be unconditional and must encompass all shares of the target. The consideration may be offered in cash or by alternative means, provided that complete and no less favourable payment in cash is always available upon demand. The consideration offered under a mandatory offer must be unconditionally guaranteed by either a bank or an insurance undertaking (in each case authorised to conduct business in Norway).

Getting the necessary finance arrangement in place may also represent a major hurdle for a bid dependent on significant leverage; in particular when it comes to mandatory offers, since any debt financing the bidder relies on in these situations must, in practice, be agreed on a "certain funds" basis, so that it does not include any conditions that are not effectively within the bidder's control.

A PE fund desirous to take private a public target should also seek support from the target's management team as early as possible since these persons are often required to co-invest together with the fund (see question 2.3 above). In connection with structuring of relevant management co-investment arrangements, the principle that all shareholders must be treated equally in a voluntary and mandatory offer situation imposes some constraints on the terms that can be agreed with employees that hold (or have options to hold) shares in the target. At the outset, the PE fund may, without limitations, approach an employee of the target and agree upon whatever terms desired, provided, of course, that such terms are not contrary to good business practice and conduct, or in violation of rules and regulations pertaining to what considerations a member of a company may or may not accept in connection with such member's position in the company. As there are no explicit legal constraints on what can be agreed regarding severance terms for directors or senior executives in the target, entitlements provided under such arrangements are likely to be permitted and upheld

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insofar as the arrangements do not give such employees unreasonable benefits at the expense of other shareholders in the target. The foregoing is naturally assuming that no limitations follow from the possible board declarations on fixing of salaries or other remuneration schemes approved by the target's general meeting. Although not specifically pertaining to the aforementioned, please take particular note that Norwegian law restricts the employees' and directors' right to accept remuneration from anyone outside the target in connection with their performance of assignments on behalf of the target.

In relation to the foregoing, it should also be noted that a bidder must disclose in the offer document what contact he has had with the management or governing bodies of the target before the offer was made, herewith including any special benefits conferred or agreed to be conferred upon any such individuals. Furthermore, when dealing with employees who are also shareholders in the target, a bidder should be aware that agreed upon terms and benefits that are not exclusively related to the employment of such shareholder may, in accordance with the principle of equal treatment, be considered as part of the offered share price, thus exposing the bidder to the risk of having the offer price in the offer document adjusted to such higher amount.

If a Norwegian-listed company becomes subject of a take-private proposal that materialises in a voluntary or mandatory offer to the shareholders, the board is obliged to evaluate the terms of the offer and issue a statement to its shareholders describing the board's view on the advantages and disadvantages of the offer. Should the board consider itself unable to make a recommendation to the shareholders on whether they should or should not accept the bid, it is to account for the reasons why. According to the Code of Practice, it is recommended, that the board arranges a valuation for each bid by an independent expert, and that the board on such basis forms its recommendation on whether or not to accept the offer. Exemptions apply in situations where a competing bid is made. The recommendations of the Norwegian Code of Practice go beyond the requirements of the STA.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

As a starting point, break fees are available in the sense that Norwegian takeover legislation does not contain particular provisions prohibiting it. However, due to strict rules regarding corporate governance and fiduciary responsibilities, the use of break fees is decisively less common in Norwegian public-to-private transactions compared to other jurisdictions. Break fees payable by the target can raise issues in relation to compliance with the target's corporate interests and may, in the worst case, trigger liability for misuse of the target's assets. Break fee agreements limiting the ability of a target's board to fulfil its fiduciary duties, or that may put the target in financial distress if the break fees become effective, are likely to be deemed unenforceable and, consequently, may result in personal liability for the board members. Potential financial assistance aspects of a break fee arrangement must also be considered carefully.

In relation to the above, it should be noted that the Code of Practice recommends that a target's board must exercise great caution in agreeing to any commitment that makes it more difficult for competing bids to be made from third-party bidders or may hinder any such bids. Such commitments, including break fees, should be clearly and evidently based on the shared interests of the target and its shareholders. According to the recommendations, any agreement for break fees payable to the bidder should, in principle, be limited to compensation for costs incurred by the bidder in making the bid. Break-up fees occur, often in a range of 0.8% to 2.0% of the target's market-cap. Of the seven public M&A offers launched during 2018, a break fee of 4.66% of the offer price was agreed for one of these deals, and a cost cover fee of around 1.18% was agreed in another.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

As a general observation, it seems that PE funds on the buy-side often prefer transactions based on completion accounts. When on the sell-side, however, the same funds tend to propose a locked-box mechanism. Having said this, the choice of preferred completion mechanics is normally decided on the basis of what kind of business the target is engaged in, i.e. whether it is particularly susceptible to seasonal variations or other cash-flow fluctuations throughout the year, and the timing of the transaction, i.e. expected closing date. Completion accounts remain a common feature if: (i) there is an expected delay between signing and completion of the transaction; (ii) the business being sold is to be carved out from a larger group; (iii) substantial seasonal fluctuation in the target's need for working capital is expected; and (iv) a large part of the target's balance sheet refers to "work-in-progress" items.

If completion accounts are proposed by a PE fund, it is common to base the calculation of the purchase price on the target's enterprise value adjusted to reflect both (i) the net cash/debt position of the target group at completion, and (ii) any deviation from the normalised working capital level at completion. A seller may also propose different variations of this methodology, e.g. by fixing the purchase price in the SPA but at the same time assuming a "*target level*" of debt and working capital. On rare occasions, other adjustment mechanisms are proposed depending on the target's industry, e.g. adjustments based on the target group's net financial assets, etc.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

The catalogue of vendor representations, warranties and indemnities offered to prospective buyers varies significantly from transaction to transaction, where it more or less comes down to bargaining power and leverage; if there is great competition for a target, only limited warranties will be given, and if the target is less sought after, then a more extensive warranty catalogue may be obtained.

The typical packages of warranties and indemnities offered by a PE seller in the Norwegian market can, to some extent, also be influenced from market practices in the fund's home jurisdiction. It is, for example, a well-known fact that many UK Sponsors rarely want to provide business representations and warranties, which means that the PE fund will try to limit the warranty package to so-called *fundamental warranties* (i.e. ownership to shares, valid execution of documentation, etc.). Instead, these sellers will attempt to make the buyer rely on its own due diligence and, if possible, by warranties provided by the target's management team. This means that when such Sponsors are attempting an exit of a Norwegian portfolio company, they may attempt to apply the same practice depending on what they expect is the most likely "buyer-

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universe" for the relevant assets. This being so, such an approach is rarely seen in the Norwegian market, at least if the seller is a Norwegian or Nordic PE fund.

Throughout 2015 and 2016, sellers in general had to accept a fairly broad set of representations and warranties if they wanted a deal to succeed in the Norwegian market, and the warranty catalogue remained at least as extensive in 2017 and 2018. During this period, buyers often succeeded in broadening the scope of the warranty coverage; for example, by including some type of information warranties in the contracts. However, exceptions did apply, especially in particular sectors, depending on the parties' bargaining position. For some extremely attractive assets sold through dual-tracks, we also witnessed that PE vendors in some situations managed to get away with a very limited set of fundamental warranties (only), and where the buyer had to rely completely on a warranty and indemnity insurance.

In general, the representations and warranties packages offered by a typical PE vendor in the Norwegian market will be fairly limited, but may, at first glance, not look too different from what a strategic seller may propose in its first draft.

Foreign Sponsors should note that, historically, it has not been very common that Norwegian or Nordic Sponsors insist on the Investing Management providing separate management warranties in connection with their co-investments or rollovers. If the management team provides such management warranties, the warranties are often limited in scope. International Sponsors unfamiliar with the Norwegian market often find such a practice strange and may therefore insist that the Investing Management provide such warranties in line with what is common in other jurisdictions.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

As in most other jurisdictions, a PE fund's starting point will often be that they do not provide any restrictive covenants. The same applies for wide confidentiality provisions; the reason being that such clauses may restrict the ability to use knowledge acquired during the lifetime of the investment for future investments. However, depending on market conditions, and the respective party's bargaining position, most funds are willing to adapt their "policy" in order to secure the exit, and non-compete and non-solicitation clauses between 12 and 24 months are seen.

In a Norwegian transaction, it is not customary for a buyer to require warranties on "an indemnity basis" like in the US, and a seller will normally resist such an approach and instead provide indemnities for specific identified risks. However, indemnities are common in share purchase agreements and asset purchase agreements. Indemnities mainly cover potential claims, losses or liabilities that the buyer has revealed during due diligence and that have not been addressed as a "to be fixed" issue or by a price reduction. In general, all PE funds are looking for a complete exit with cash on completion and, depending on at what stage of the fund's lifetime the exit takes place, such funds will normally seek to resist or limit any form of indemnification clauses in the SPA.

Nevertheless, as long as the PE fund selling is Norwegian or Nordic, it has not been common to insist that a buyer relies solely on indemnities provided by the management team. Instead, the PE funds have tried to accommodate buyer's requests for indemnities, but at the same time introduce special caps and deadlines for such potential liability. To the extent possible, the PE vendor might also attempt to insure all potential liability claims, but some diligence findings may often be of such nature that insuring it is rather difficult. In some cases, the insurance premium is also so high that it is better to negotiate an appropriate price reduction. Warranty and indemnity ("**W&I**") insurances, including special claims insurances, have, however, started to become increasingly popular in the Norwegian market (see question 6.4 below).

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

W&I insurance has historically not been a common feature in the Norwegian deal landscape. However, during 2013 and throughout 2018, the Norwegian market witnessed a substantial growth in the number of transactions in which the seller or the buyer attempted to use W&I insurance as a way to reach agreement on liability under the SPA (or, alternatively, introduced by a buyer in order to achieve a competitive advantage in a bidding process). For 2018, we estimate that close to 20% of all M&A deals in Norway used this type of insurance.

The W&I insurance product has become particularly popular among PE funds seeking a clean exit. Such funds have now started to arrange "stapled" buy-side W&I insurance to be made available to selected bidders in structured sales processes. Such insurances have also been used as a tool for the PE fund in order to get rid of the escrow clause in the SPA. Typical carve-outs/exclusions under such policies will comprise: pension underfunding; projections; transfer pricing issues; anti-bribery; secondary tax obligations; and uninsurable civil fines or penalties. For more on excess/policy limits, see question 6.5 below. The cost of such insurance depends on the industry in which the target operates, the type of insurance coverage requested, the target itself and the parties involved, but will typically be in the range from around 0.8% to 1.8% of the insured amount.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Save in respect of vendor liability for locked-box leakage or breach of specific restrictive covenants, which are normally subject to special liability regulations (please see question 6.3), a PE vendor will normally attempt to include several limitations on its potential liability for breach of the SPA and its obligations, covenants, warranties and indemnities thereunder. Significant variations will apply depending on the market conditions, the parties' bargaining position, the target's industry sector and individual circumstances.

Historically, if a PE fund was on the sell-side, it would very often start off with proposing a six to 12-month limitation period for the general warranties, and a period of between 12 and 24 months for the tax warranties. However, the introduction of the W&I insurance product has led some of the Norwegian funds to become slightly more generous with the length of the limitation periods offered in their first draft of the SPA. The main reason is that the insurance market is able to offer a 24-month limitation period for the general warranties, and between five and seven years on tax warranties at a very little price difference compared to shorter limitation periods.

A PE vendor will typically (but depending on the market conditions) also start off with proposing a relatively high "*de minimis*" (single loss) threshold combined with a basket amount in the upper range of what traditionally has been considered "market" in Norway for such limitation provisions. PE funds exiting their investments today may

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also attempt to align the basket amount with the policy "excess amount" under W&I insurance. This typically means an amount from 0.5% to 1% of the target's enterprise value, depending on the insurance market and which insurance provider is underwriting the policy. The standard policy excess amounts offered by the insurance industry is normally 1% of enterprise value, which is above historical level of what has been considered market value for the basket-amounts in Norway, but currently an increasing number of insurers are willing to offer 0.5% of the enterprise value as the policy excess amount. While the majority of the deals in the Norwegian market traditionally are done with a "tipping basket" (whereby the seller is responsible for all losses and not just those exceeding the basket amount), an exiting PE fund may propose a "deductible basket" (whereby the seller is only responsible for losses in excess of the basket amount). The result in the final SPA depends on market conditions and the bargaining position of the parties involved. A PE vendor will also normally propose to cap its total liability at the lower end of what is market, for example by proposing an overall liability cap of 10% of the purchase price.

Finally, note that it has thus far not been tradition among Norwegian PE funds, as sometimes seen when international PE funds exit investments, to propose a different set of warranties and indemnities for the PE fund and the target's management team (see question 6.3) and thereby also a different set of limitation rules for the management. However, in the event that the buyer is an international PE fund and the management team has to rollover parts of its investments, such international funds may want to request that the Investing Management in the co-investment agreement/ shareholders' agreement provides the fund with separate representations and warranties (see question 6.3).

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

As mentioned in questions 4.2 and 6.4, PE vendors will, by virtue of seeking a clean exit without any clawback or similar post-closing issues, rarely accept security arrangements like escrow accounts unless absolutely necessary. Depending on the circumstances, PE buyers may insist to include escrow provisions into the SPA as security for sellers' warranties/liabilities. As with most other elements in a given transaction, however, this comes down to prevailing market conditions and the parties' relative bargaining positions. It has not been common practice among Norwegian PE funds to request that the target's Investing Management in the co-investment agreement/shareholders' agreement provides the fund with separate representations and warranties (see question 6.3). As alluded to in question 6.5, such arrangements are, however, seen if the buyer is an international PE fund and the management team has to rollover parts of its investments.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

The sellers' process letters to PE buyers will normally instruct that a buyer's final bid must be fully financed (i.e. expressly state that it is not subject to financing), and that the sources thereof must be reasonably identified. If financing is to be provided by external sources, the final bid must also provide the terms and status of all such financing arrangements (including any commitment letters), as well as the contact details of the relevant institutions providing financing (the buyer is often requested to inform the institutions that a seller's representative may contact them).

It has become common that sellers insist that the SPA contains buyer warranties regarding the equity financing commitment (if applicable to the transaction). A PE fund is often required to provide an equity commitment letter to backstop its obligation to fund the purchasing vehicle ("BidCo") immediately prior to completion. However, such equity commitment letters will often be addressed to the TopCo in the string of holding companies that owns BidCo (or to a subordinated HoldCo further down in the string of holding companies). The enforceability of such equity commitment letters is most often qualified upon a set of conditions, and the PE fund's liability under the letter is, in all events, capped at a designated committed amount.

In respect of the above, a seller should note that Norwegian corporate law adheres to the concept of corporate personhood, whereby a company is treated as a separate legal person, solely responsible for its own debts and promises, and the sole beneficiary of credits it is owed. Related parties will thus not incur liability for a company's promises/guarantees, and a Norwegian court of competent jurisdiction will only in exceptional circumstances (e.g. in connection with legal charges of fraud or tax evasion) pierce the corporate veil through application of the alter ego doctrine. As such, guarantees that furnished a seller exclusively by BidCo (by way of copies of a commitment letter or other form of promissory notes issued to BidCo) will only be enforceable against BidCo, which normally does not have any funds besides its share capital (in Norway the minimum share capital for a LLC is NOK 30,000). Consequently, a careful seller will often require a limited right to enforce the equity commitment letter directly against the PE fund itself.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break/termination fees have historically not been prevalent in Norwegian PE transactions, and PE funds have rather sought to make their obligation to consummate the transaction conditional upon receiving required financing, without having to pay any form of fees to the sellers. To what extent sellers are willing to accept such conditions normally depends on the market situation and the respective parties' bargaining positions. Such financing out conditions/clauses have not disappeared in today's market, but sellers tend to resist these types of conditions.

Over the last few years, we have observed that the use of reverse break fees is on the rise (albeit very slowly), and whereas virtually no M&A transactions in the Norwegian market included reverse break fees a few years ago, our PE clients have regularly, during the last few years, enquired about its feasibility.

The amount of a reverse break fees is largely a matter for negotiation and will therefore vary in each individual transaction. Typically, however, the fees are agreed at a fixed amount in the range of 1% to 2.5% of transaction value.

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7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

From a PE perspective, three main considerations guide the determination of whether an IPO exit is the right choice. The first, which goes to the very nature of the PE model, is whether the PE fund through an IPO exit achieves the best possible price for its shares, while at the same time reducing its exposure (shareholding) to an acceptable level. A successful IPO often requires that investing shareholders receive a discount of between 10% and 15% on the regular trading price, and the PE fund seldom manages to offload 100% of its shareholding. A clear strategy for continued ownership is thus imperative, especially considering that a larger shareholder's planned/impending sale (typically upon expiry of relevant lock-up periods) will put substantial negative pressure on the share price. Another key element in terms of achieving the best sales price will be the formulation of a powerful equity story, which, in essence, is the sales-pitch and reasoning why investors should pick up the share. For PE funds, the equity story highlights the strong sides of the target in a growth perspective, with focus on a high appreciation potential – the value perspective, accentuating expectations of low appreciation and high dividends is normally not relevant for PE-backed portfolio companies. Timing is also of essence, and sometimes the window of opportunity is simply closed due to prevailing market conditions. If that is the case, an alternative approach can be to carry out a private placement in advance – either in order to raise both new equity and new shareholders, or just for raising new equity and to take the spread upon the listing itself.

The second main deliberation a PE fund contemplating an IPO exit must make is of whether the target is ready, willing and able to go public. Irrespective of excellence, the public investor market for the relevant industry sector may simply be saturated, and, in such a situation, a newcomer will most likely struggle severely to get both traction and attention. From an internal point of view, there are also the household tasks of getting procedures and regulations up to STA standards and listing requirements, preparing financial and other pertinent investor documentation, and training management and key personnel, whom frequently have very limited insight into the dynamics and requirements of a public company in terms of governance, reporting, policy implementation, etc.

Thirdly, and assuming the target is deemed suitable for listing and that all elements above have undergone careful scrutiny, the PE fund must consider whether it is prudent to place all its eggs in the IPO basket, or whether it is smarter to initiate a dual-track process – combining the IPO exit with either a structured or a private (bilateral) sales process. Such a process may either be a "true parallel" (where both routes run parallel and ultimate decision is deferred to final stages), "staggered" (where the M&A process front-runs the IPO process and the ultimate decision is made after receipt of second round bids), or an "IPO-led hybrid" (where both routes' preparation and progress is dictated by the IPO timeline). The process of preference notwithstanding, the obvious advantages of initiating a dual-track process is a better understanding of market value and investor/buyer universe, increased flexibility, and reduction of transactional risk – each track is effectively the fail-safe of the other. On the reverse comes added and often concurrent work streams, prolonged timelines, the inherent risk of prematurely deviating from the dual-track (which may cause internal friction and stoppages) and, of course, the additional advisor costs.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

Although significant variations may apply, Managers are normally subject to a 180-day lock-up period from listing (the last couple of years we have seen examples as high as 360 days). Lock-up periods for co-investing management are somewhat less common, but, if imposed, tend to range in the region of 360 days.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

PE sellers' preferences for dual-track processes are generally subject to equity market momentum (i.e. that the capital market may offer superior valuation to M&A alternatives) but where an IPO valuation could be close to LBO valuations, and where the lead buyer(s) is less clear. Under such circumstances, dual-track exit processes are used to maintain flexibility, to help maximise valuation and for de-risking a potential IPO. Dual-track exit processes allow the sellers maximum visibility, and the decision on the M&A track should be resolved a short time ahead of launching the company's intention to float ("**ITF**") since investors do not focus during pre-deal investor education sessions until clarity on the winning track is announced. Consequently, a second round M&A process will normally run parallel to research drafting under the IPO-track. The decision on the winning track is often taken shortly before roadshow launch under the IPO-track. Whether dual-track deals are ultimately realised through a sale or IPO depends on the momentum in the equity markets but these deals have, during the last few years, often materialised in a sale.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Norwegian LBOs generally involve bank debts as the main source for financing in the form of term loans and a revolving credit facility. In large transactions, the senior loan will be governed either by Norwegian or English law, with one bank acting as an agent for a lending syndicate. In such syndicated transactions, the senior loan agreements used are normally influenced by the forms used internationally, in particular the standard forms developed by the Loan Market Association. A typical leveraged PE structure may, depending on the size of the target, contain several layers of debt. Historically, it was quite common to use a combination of senior facilities and mezzanine facilities, whereby security is granted to a security agent. In certain circumstances, the mezzanine debt was also issued in combination with warrants to purchase equity in the target. However, due to the severe hit mezzanine investors faced during and after the credit crunch, it became difficult to obtain such financing at reasonable prices, and many Sponsors started to consider mezzanine financing too expensive. Over the last six years, mezzanine financing has rarely been seen in the Norwegian market for new transactions. One of the more important reasons for this change has been the development of a very buoyant Norwegian

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high-yield bond market, which largely substituted the traditional mezzanine facilities. Such transactions would typically involve "bridge-financing commitments" pursuant to which either a bank or a mezzanine provider agrees to provide "bridge" loans in the event that the bond debt cannot be sold prior to completion. Due to a rapid decline in oil prices during 2014 and 2015, the Norwegian high-yield bond market took a severe hit from October 2014 and onwards throughout most of 2016. However, since the beginning of 2017 and throughout 2018, the Norwegian high-yield bond market has improved significantly, at least within certain selected industries.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

Until 1 July 2013, when the Norwegian Parliament approved amending the previous strict ban on financial assistance, Norwegian targets (public and private alike) were generally prohibited from providing upstream financial assistance in connection with the acquisition of themselves or their parents. From the outset, this prohibition prevented such targets from participating as co-borrowers or guarantors under any acquisition-financing facilities, but, in practice, there were a number of ways (not considered as breach of the prohibition) to achieve at least a partial debt pushdown post-takeover through refinancing of the target's existing debt.

Under the rules of 2013, which introduced a type of "whitewash" procedure, both private and public targets can now (subject to certain conditions) provide funds, offer loan/credit arrangements and grant security in connection with an acquisition of shares (or share rights) in themselves of their parents, but only within the limits of what such target otherwise legally could have distributed as dividends. If granted, financial assistance must be provided on commercial terms and conditions, and a buyer must deposit "adequate security" for its obligation to repay such assistance received. Furthermore, the assistance must be approved at the target's general meeting by a special resolution, which requires the same majority as needed to amend the articles of association (i.e. ⅔ of the shares and votes represented, unless the articles of association contains stricter voting requirements). In addition, the target's board must prepare a special report that contains information on: (i) the proposal for financial assistance; (ii) whether or not the assistance will be to the target's corporate benefit; (iii) conditions that relate to the completion of the transaction; (iv) the impact of the assistance on the target's liquidity and solvency; and (v) the buyer's price for the shares (or rights to shares) in the target. This report shall be attached to the summons for the general meeting and for public LLCs, and the report must also be registered with the Norwegian Register of Business Enterprises (**"RBE"**) before the assistance is provided. For governance purposes, the target's board is finally required to obtain a credit rating report on the party receiving the assistance.

The rule's requirement for depositing "adequate security" for the target's borrower's obligation to repay any upstream financial assistance provided by a target in connection with M&A transactions, means that it is quite impractical to obtain direct financial assistance from the target in most LBO transactions, due to the senior financing banks' collateral requirements in connection with such deals. Consequently, in practice, the rules have had little impact on how LBO financing is structured under Norwegian law, at least in PE LBO transactions. Therefore, in most cases, the parties continue to pursue debt pushdowns by refinancing the target's existing debt, the same way as previously adopted. Note that in early 2016, the Ministry of Trade, Industry and Fisheries proposed to amend the current requirement for adequate security. It is currently unclear when and whether the proposal will be implemented. If the Ministry's proposal is finally adopted by Parliament as originally proposed, it means that it will also for LBO-transactions become possible for a buyer to receive financial assistance from the target in the form of security for that buyer's acquisition financing.

From 1 July 2014, Sponsors must also ensure that they observe the anti-asset stripping regime that is set out in the Act on Alternative Investment Fund Managers (see question 10.2). These rules may limit the Sponsor's ability to conduct debt pushdowns, depending on the status of the target (listed or non-listed), the number of employees in the target and the size of the target's revenues or balance sheet.

Further note that the power of a Norwegian entity to grant security or guarantees may, in some situations, also be limited by the doctrine of corporate benefit. Under Norwegian law, it is uncertain if a group benefit is sufficient when there is no benefit to the individual group company; for example, in connection with such individual group company granting a guarantee or providing a security. Previously, it has been assumed that Norwegian companies are able to provide upstream and cross-stream guarantees, provided that: (i) this will not jeopardise its continuing existence; (ii) its corporate objects are not transgressed by such transactions; (iii) it can be argued that such cross guarantees benefiting the Norwegian company exist or that the relevant group company receives any type of guarantee fees; and (iv) such guarantees and securities are not in breach of the financial assistance propitiation. However, an amendment to the Companies Acts from 2013 now seems to indicate that a group benefit *may* be sufficient when issuing an intra-group guarantee, even if there is no direct benefit to the individual group company issuing the guarantee.

Finally, PE funds' use of various forms of shareholder loans and inter-company debt, supported by various intra-group guarantees in LBO transactions, could also trigger a need for shareholder approval in the various group companies in order to be valid. This could turn out to be necessary unless such loans are entered into as part of the relevant subsidiaries' ordinary course of business activity and contain prices and other terms that are normal for such agreements. In legal theory, it has, however, been argued that intra-group loan agreements entered into in connection with M&A transactions very often must be considered to fall outside the normal business activity of the respective company receiving such financing and, therefore, under all circumstances must be approved by such company's shareholders.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

For the last few years, we have started to see increased activity from non-bank (alternative) lenders and funds which are offering to replace or supplement traditional senior secured bank loans. The products these lenders are offering typically include term loan B facilities, unitranche loans, etc.

In addition, an increasing number of banks also seems willing to offer PE funds so-called "capital call facilities", "subscription facilities" or "equity bridge facilities" to provide short-term bridge financing for investments, ultimately financed from capital contributions from the limited partners of the PE funds.

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9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Key tax considerations relating to Norwegian PE acquisitions typically include: (i) quantification of the tax costs associated with the acquisition; (ii) management of tax charges of the target group; (iii) exit planning (including a partial exit); and (iv) tax-efficient compensation to the management of the target group. Most Sponsors operating in the Norwegian market quite commonly use offshore structures for achieving a tax-efficient acquisition structure.

Costs of acquisition

No stamp duties, share transfer taxes or other governmental fees apply in connection with a share sale under Norwegian law. The tax treatment of transaction costs depends on whether these are classified as costs for acquisitions/disposals, operating costs, or debt financing costs.

As a general principle, all transaction costs incurred directly in connection with an acquisition of shares should be capitalised for both accounting and tax purposes with the acquired shares. This means that the costs are non-deductible for corporation tax purposes. Instead, transaction costs related to the acquisition should be added to the tax base cost of the shares and may therefore reduce any capital gain arising upon a subsequent disposal (to the extent the disposal is not covered by the Norwegian participation exemption rules). Note that, according to the Norwegian participation exemption rule, Norwegian shareholders being limited companies and certain similar entities (corporate shareholders) are generally exempt from tax on dividends received from, and capital gains on the realisation of, shares in domestic or foreign companies domiciled in EU and EEA member states. Losses related to such realisation are not tax-deductible. Since normally both the target and BidCo used by the PE fund will be LLCs domiciled in Norway, the acquisition costs in connection with a share-deal will not effectively be deductible under the current Norwegian tax regime.

Notwithstanding the above, certain expenses incurred by a company in connection with the ownership of shares/subsidiaries (i.e. costs for corporate management and administration, strategy work and planning, marketing costs, financing costs, restructuring costs, etc.) may be deductible on a current basis for corporate tax purposes under Norwegian law. Taking effect from 1 January 2016, a rule was implemented clarifying that broken-deal expenses which incurred in connection with failed acquisitions of shares in another company (typical expenses relating to due diligence) are no longer deductible for tax purposes.

In principle, costs of arranging the financing (i.e. fees in connection with obtaining and maintaining debt, bank charges and associated advisory/legal fees) will be deductible but must be spread over the period of the loan as an interest expense (i.e. amortised). The deductibility of such costs may, however, become subject to the Norwegian interest-deduction limitation regime (see below).

The acquisition vehicle will, in addition, seek to maximise its recovery of VAT incurred in acquiring the target (particularly in relation to advisory fees). This is a difficult area that has started to attract increased scrutiny from the Norwegian tax authorities. The tax authorities will now argue that input VAT on advisory fees in relation to acquisition of shares in general is not recoverable/deductible for VAT purposes.

Target group tax management

In order to reduce the buyer's effective tax rate, PE funds are desirous to offset the interest costs on the acquisition debt against the operating target group's taxable profit. Consequently, the acquisition structure is normally established to maximise the amount of financing costs that can be offset against the operating profit of the target group. Where the target group is multinational, the fund will also desire that such costs can be "pushed down" into the jurisdiction that has profitable activities without the imposition of additional tax costs such as withholding taxes. Additional tax minimisation techniques may also be used to manage the target group's tax charge. Parts of the PE fund's investment may also be made in the form of shareholder loans, which may generate additional tax deductions, provided this can be structured in a way that current tax liabilities are not imposed on the fund's investors and Sponsors in some form of phantom income.

Historically, under Norwegian law, interest arising on related-party debt was considered deductible for tax purposes to the extent that the quantum and terms of the debt was arm's length in nature. Over recent years, the Norwegian tax authorities have taken an increasingly aggressive approach in challenging leveraged structures, in particular by challenging the substance of non-Norwegian holding company structures, distributions out of liquidation and the tax deductibility of interest on shareholder debt. From the income year 2014, a new rule limiting the deduction of net interest paid to related parties also entered into force. Additional restrictions to this rule were implemented in 2016. From then the limitation rule broadly caps the interest deductions on loans from related parties to 25% of the borrower's "taxable earnings before interest, tax, depreciation, and amortisations". The rule aims to eliminate, or reduce the risk of, the Norwegian base being excavated as a result of tax planning within international groups where the debt has been allocated to the Norwegian group companies. The term "related-party" covers both direct and indirect ownership or control, and the minimum ownership or control required is 50% (at any time during the fiscal year) of the debtor or creditor. Please note that a loan from an unrelated party (typically a bank) that is nevertheless secured by a guarantee from another group company (i.e. a parent company guarantee), will also be considered as an intra-group loan coming under these rules. Companies with total interest expenses (both internal and external) of NOK 5 million or less are not affected by these limitation rules.

According to a regulation adopted by the Ministry of Finance, interests paid under a loan secured by a related-party is not subject to the interest limitation rule if the security is a guarantee from the related-party of the borrowing company, and such related-party is a subsidiary owned or controlled by the borrowing company. The same exemption applies on loans from a third party secured by a related-party of the borrowing company if such related-party security is either (i) a pledge over that related-party's shares in the borrowing company, or (ii) a pledge or charge over that related-party's outstanding claims towards the borrowing company. For security in the form of claims towards the borrower, it is not required that such claim is owned by a parent company. Negative pledges provided by a related-party in favour of a third-party lender are not deemed as security within the scope of the interest limitation rule. Consequently, in a situation where the acquisition vehicle is excessively leveraged from a tax point of view, any interest over and above the limitation rules will be non-deductible. With effect from 1 January 2019, interest payable on bank facilities and other external debt within consolidated group companies have now also become subject to the same interest deduction limitation regime as interest paid to "related parties". This new amended rule only applies if the annual net interest expenses exceed NOK 25 million in

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total for all companies domiciled in Norway within the same group. At the same time, two escape rules have been implemented that aim to ensure that interest payments on loans from third parties not forming part of any tax evasion scheme still should be tax-deductible. Following implementation of the new rules, the old rules will still apply but only to interest paid by Norwegian enterprises to a related lender outside of the consolidated group (typically where the related lender is an individual). Note that the government has indicated that separate interest deduction limitation rules may be introduced for enterprises within the petroleum sector. Further note that the EFTA Surveillance Authority has resolved to challenge the Norwegian interest limitation rules (see below under question 11.1).

Also note that the acquisition vehicle itself is unlikely to have profits against which to offset its interest deductions. Therefore, it is critical for the Norwegian holding companies in the acquisition structure to be able to offset its interest expenses against the possible profits generated by the target's operations. Norwegian companies cannot file consolidated tax returns or form fiscal unities, but a transfer of taxable income within an affiliated group of Norwegian entities is possible through group contributions in order to offset taxable profits against tax losses in another Norwegian entity. It is possible to grant more group contribution than taxable income, but the grantor company will not be able to deduct the excess amount. This excess amount, which is not deductible for the grantor, would equally not be taxable for the recipient. The distributable reserves form the limit for total group contribution and dividend distribution. In order to enable group contributions, the contributing and receiving entities must be corporate entities taxable in Norway, an ultimate parent company must hold more than 90% of the shares and voting rights of the subsidiaries (either directly or indirectly) at the end of the parent's and the subsidiaries' fiscal year, and the companies must make full disclosure of the contribution in their tax returns for the same fiscal year.

Norway does not levy withholding tax on interest payments to foreign lenders, nor on liquidation dividends to foreign shareholders. Nevertheless, see question 9.4 below with regard to expected changes to the current tax regime. Normally, in a typical LBO, it will not be envisaged that any dividends will be made by the Norwegian holding company structures during a PE fund's investment period except in respect of potential partial exits. However, in the event that any distributions from the Norwegian holding company structure are required prior to exit, Norwegian withholding tax on dividends will need to be considered. The potential applicable withholding tax rate depends on the respective tax treaties and (typically) on the foreign shareholder's ownership percentage in the Norwegian holding companies. No withholding tax is imposed on dividends or liquidation dividends paid by a Norwegian LLC to an EEA-resident corporate shareholder, provided the shareholder is genuinely established and conducts real business activity in the relevant jurisdiction. Furthermore, the EEA-resident corporate shareholder must be comparable to a Norwegian LLC. In this context, an assessment must be performed to determine whether the company is genuinely established pursuant to a business motive and that the establishment is not purely tax motivated. The assessment will differ according to the nature of the company in question, and it is assumed that the assessment of a trading company and a holding company will not be the same. If such criteria are not met, then the withholding tax rate in the applicable double-taxation treaty for the relevant jurisdictions involved will apply. Also note, if such a foreign holding company is considered an agent or nominee for another real shareholder (not a legal and economic owner of the dividends) or a pure conduit company without any autonomy to decide what to do with its income, the Norwegian tax authorities may apply the default 25% withholding tax rate (i.e. not accept treaty protection). Foreign buyers of Norwegian assets should thus be cautious when setting up acquisition structures and include tax reviews of any prior holding structures when conducting due diligence.

Also note that dividends received by a Norwegian company on business-related shares in group subsidiaries within the EEA held directly or indirectly with more than 90% inside the EEA are also exempted from Norwegian corporate tax on the part of the receiving corporate shareholders. However, a 3% claw-back rule will apply to dividends received by corporate shareholders holding less than 90% of the shares as well as to foreign corporate shareholders having a permanent establishment in Norway that receive dividends from Norwegian companies, subject to such foreign corporate shareholders participating or carrying out business in Norway to which such shareholdings are allocated. Under such circumstances, 3% of such dividends are subject to Norwegian taxation as ordinary income at a tax rate of 22% (reduced from 23% as per 1 January 2019) (giving an effective tax rate of 0.66%).

Exit planning

In general, it is of vital importance to PE funds that all potential exit scenarios are anticipated and planned for when formulating the final acquisition structure. This means that the advisors need to consider a full exit, partial exit, IPO, etc.

As described above, the ultimate parent company in the acquisition structure will quite often be a non-Norway resident entity. Non-Norway domiciled carried interest holders are thus able to benefit from the remittance basis of taxation in respect of carried interest distributions arising from an exit. Having said this, it is nevertheless critical that any exit can be structured in such way that it does not trigger any withholding tax or other tax leakages and, where possible, that any exit proceeds can be taxed as capital gains for investors, carry holders and management. As described earlier, Luxembourg holding companies (**"LuxCo"**) are often used to achieve such objectives.

Executive compensation

In addition to receiving salaries, which under Norwegian law is subject to income tax and national insurance contributions in the normal way, members of the target's management team (the Investing Management) will normally also be offered an opportunity to subscribe for shares in BidCo. To the extent that the Investing Management pays less than the market value of such shares, this could give rise to an employment tax charge (see above under question 2.3). As employers' contributions to the social security tax are deductible, the effective rate for the employer should be lower. Normally, the PE fund will split its investment between ordinary equity and preferred equity or debt, while the Investing Management invests in ordinary shares. As a result of this, the ordinary shares will normally have a low initial market value, but with the potential to appreciate significantly if the acquired business generates the PE fund's desired IRR. In order to avoid accusations that the Investing Management were allowed to subscribe their shares at a price lower than market-price, it is fairly normal that the value of the Investing Management's shares is confirmed by a valuation carried out post-acquisition. It is further not uncommon that particular foreign PE funds require that members of the Investing Management accept an appropriate indemnity in the shareholders' agreement to cover any potential employment tax obligations arising as a result of the Investing Management's equity investment.

Any employment taxes arising because of Investing Management obtaining shares at a discount must be reported to the Norwegian tax authorities immediately after the transaction in the relevant tax period.

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9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

The most common tax-efficient arrangement considered by management teams in PE portfolio companies is to structure the managements' equity participation via private holding companies to benefit from the Norwegian participation exemption rule. Under Norwegian law, arrangements such as growth shares and deferred/vesting arrangements may entail a risk that parts of any capital gains will be subject to employment income tax and social security, although this liability will only arise when such shares are sold, provided such shares when acquired were acquired or subscribed at their fair market value. If, however, such securities are considered discounted, such discount will be chargeable to income tax at the relevant employee's marginal tax rate and will be subject to social security tax.

No similar rules to the UK "entrepreneurs' relief" exist under Norwegian law. International PE-funds may still want to structure their management investment programmes in Norwegian portfolio companies to meet the conditions for such relief in case existing or future members of the investing management team would qualify for such relief due to their current tax domicile.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

The key tax considerations for Investing Management selling and/or rolling over part of their investment into a new acquisition structure, include:

- Rollover relief:
  - For individual shareholders, as a starting point no statutory rollover relief exists that allow shares to be exchanged for shares without crystallisation of a capital tax charge.
  - If Investing Management has invested through a separate holding company or pooling vehicle, the Norwegian participation exemption rule will allow rolling over part of such investment into a new acquisition structure without triggering capital tax charges.
  - Subject to certain conditions being fulfilled, a rollover-relief could be achieved in cross-border transactions also for individual shareholders.
- Exchanging shares for loan notes:
  - For individual shareholders, this will not qualify for rollover relief, and will attach a tax charge.
  - If the selling management team's investment is structured through separate holding companies or a pooling vehicle, exchanging shares for loan notes will, under the Norwegian participation exemption rule as a starting point, not trigger any tax charges.

Other key issues that need to be considered are: to what extent will any members of the team be subject to tax if the target or the PE-fund makes a loan to members of the team to facilitate the purchase of equity? Will tax and social security contributions be due if such loans are written off or waived by the lender? Note that from 1 January 2016, loans from a Norwegian company to any of its direct or indirect shareholders being private individuals (or to such shareholders' related parties) will be taxed as dividends on the part of such individual shareholder (see question 9.4 below). Investing Management must also consider if any restrictions to the transferability and other terms at which new shares/financial instruments will be acquired may affect the income tax treatment of such instruments. Too close links to the employment can lead to the re-characterisation of the income/gains from such instruments. For more issues, please see questions 2.3 and 9.1 above.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

There are no explicit Norwegian tax regulations regarding distribution of Carry to the managers in exchange for their services, and the prevailing view was, until recently, that insofar such managers invest capital into the funds, the Carry must be considered capital gains and taxed at capital gains rates, and if the Managers are organised as LLCs, such corporate shareholders' income in form of dividends and gains on shares/ownership interest in other companies would also be exempt from taxation in accordance with the Norwegian exemption method.

In the past few years, Norwegian tax authorities started to challenge the above view by seeking to treat Carry as ordinary income and thus subject it to income taxation (which is higher than taxation rates for capital gains). This culminated in a legal process between the tax authorities, a Manager called Herkules Capital and the Manager's three key executives and ultimate shareholders (the "**Key Executives**"), which in November 2015, found its conclusion when the Norwegian Supreme Court rejected the tax authorities' attempt to reclassify Carry from capital gains to personal income for the Key Executives.

In 2013, the District Court rejected the tax authorities' primary claim that Carry must be considered as income from labour subject to income taxation. The court also rejected the tax authorities' argument that distributions from a PE fund to the Key Executives must be subject to payroll tax (14.1%). The District Court concurred, however, with the tax authorities' alternative claim that Carry is subject to Norwegian taxation as ordinary corporate income for the Manager at the then prevailing tax rate of 28% (now 22%). On appeal, the decision was overturned and the Norwegian Court of Appeal upheld the tax authorities' original tax assessment, i.e. that Carry must be considered as corporate income for the Manager, salary income for the Key Executives, and that that the distribution to the Key Executives accordingly was subject to payroll tax. Finally, the court ordered the Key Executives to pay 30% penalty tax on top. In November 2015, the Norwegian Supreme Court overturned the Court of Appeals and invalidated the tax authorities' assessment. The Supreme Court concluded that Carry (in this case) should be considered as ordinary corporate income at the then prevailing tax rate of 28% (now 22%), but that such an income could not be considered as salary income for the Key Executives. As such, there could neither be a question of payroll taxes.

Also, during 2018, the government continued to follow up on some of the previous proposals in the proposed tax reform. For example, in the Fiscal Budget for 2019, the Ministry of Finance proposed a new rule, elaborating on a previous proposal to reduce the possibility for treaty shopping by implementing rules stating that all entities established and registered in Norway in general shall be considered to have Norwegian tax domicile, unless a treaty with other states leads to a different result. This rule will also apply on companies previously established and registered in Norway but having later moved their tax domicile out of Norway. Even companies established and registered abroad shall be considered to

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have Norwegian tax domicile, provided the management of such companies (in reality) is carried out from Norway. These new rules are now implemented with effect from 1 January 2019, or from the first fiscal year starting after 1 January 2019, but no later than 1 January 2020, and the aim is that from such time, companies registered in Norway shall never be considered "stateless".

In its proposal for the 2019 Fiscal Budget, the government also stated that it intended to issue a consultation paper later in 2018 for the proposal of adopting a rule allowing the government to introduce withholding tax on interest and royalty payments. The aim is to propose a bill to be adopted by Parliament in this regard during the course of 2019.

Further note that, from 1 January 2016, a new rule was implemented into Norwegian law which attempts to neutralise the effects of hybrid mismatch arrangements by denying corporate shareholders to apply the Norwegian participation exemption rule on distributions received from an entity which has been, or will be, granted tax deduction on such distributions.

Members of management teams should also note that from 7 October 2015, loans granted from a Norwegian company to any of its direct or indirect shareholders being private individuals (or to such shareholders' related parties) shall be taxed as dividends on the part of such individual shareholder. This rule will also apply on loans granted from third-party lenders to such individual shareholders, provided the company in which such borrower owns shares and/or another company within the same group of companies, provides security for such third-party loans.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

The Alternative Investment Fund Managers Directive ("**AIFMD**") was implemented in Norwegian law on 1 July 2014 (the "**Act**"), and applies to managers of all collective investment vehicles (irrespective of legal structure, albeit not UCITS funds) that call capital from a number of investors pursuant to a defined investment strategy (alternative investment funds ("**AIF**")).

There are two levels of adherence under the Act. The first is a general obligation to register the AIF-manager with the Norwegian FSA and provide the agency with information, on a regular basis, regarding: the fund's investment strategy; the main category of instruments it invests in; and the largest engagements and concentrations under its management. Failure to comply with these reporting requirements may induce the Norwegian FSA to demand immediate rectification, or to impose a temporary ban on the manager's and the fund's activities. The foregoing applies to all AIFs, whereas the second level of adherence (see below) only applies to funds that have either (a) a leveraged investment capacity exceeding €100 million, or (b) an unleveraged investment capacity exceeding €500 million, and where its investors do not have redemption rights for the first five years of investment. Where an AIF exceeds these thresholds, the manager must, in addition to the reporting requirements above, obtain authorisation from the Norwegian FSA to manage and market the fund's portfolio, herewith conducting its own risk assessments, etc.

From a transactional point of view, and particularly with respect to (new) obligations for PE actors operating in the Norwegian market, the Act stipulates the following points of particular interest: the **first** is disclosure of control in non-listed companies, and stipulates that if a fund, alone or together with another AIF, acquires control (more than 50% of votes) in a non-listed company with 250 or more employees and either revenues exceeding €50 million or a balance sheet exceeding €43 million, the manager must, within 10 business days, inform the Norwegian SFA. Exempt from the forgoing are acquisitions of companies whose sole purpose is ownership or administration or real property. The notification must include information about when and how control was acquired, shareholdings and voting rights of the target, any planned undertakings to avoid potential conflicts of interest and planned communication strategy *vis-à-vis* investors and employees. The target and its residual shareholders shall also be informed about the fund's strategic plans and how the acquisition may potentially affect employees. Please note that the same disclosure requirements, according to the rules, also apply if an AIF acquires control of a listed target company, irrespective of, *inter alia*, such target company's number of employees, revenues and balance sheet. **Secondly**, and ensuing an acquisition described above, the manager is under duty to inform the Norwegian SFA within 10 business days if and when the fund's shareholdings in a target either reach, exceed or fall below 10%, 20%, 30%, 50% or 75%. The **third** point of interest, legislated through the Act, is that a manager, during the 24-month period following acquisition, more or less is prohibited from facilitating, supporting or instructing any distribution, capital reduction, share redemption or acquisition of own shares of the target (portfolio company) (the so-called "anti-asset-stripping" rules). The foregoing applies if either: (a) the target's net assets, pursuant to the last annual accounts are, or following such distribution would become, lower than the amount of subscribed capital plus reserves that cannot be distributed subject to statutory regulation; or (b) such distribution exceeds the target's profit for the previous fiscal year plus any subsequent earnings/amounts allocated to the fund, less any losses/amounts that must be allocated to restricted funds subject to statutory regulation. Also, note that the above anti-asset-stripping provisions will apply to such fund's acquisitions of listed target companies irrespective of the number of employees, size of revenue or balance sheet for such listed targets. The so-called "anti-asset-stripping provisions" could, to an extent, affect a PE fund's ability to conduct debt-pushdowns in connection with LBOs going forward.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

Norway has, as in many other countries, tightened its grip on national security reviews of foreign direct investments, by implementing a new National Security Act, granting the government powers to intervene and stop acquisitions of shares in a company holding investments in sectors considered vital from a Norwegian national security perspective. It is therefore expected that PE investors' investments within such sectors or particular transactions within such sectors in the near future could become subject to enhanced scrutiny by the Norwegian government, even if this so far has not been very prevalent in the Norwegian market.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)? Do private equity investors engage outside counsel / professionals to conduct all legal / compliance due diligence or is any conducted in-house?

In a structured process, PE investors tend to limit diligence scope

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and timeframe (i.e. only key issues/areas of interest) and only request a very limited and preliminary "red-flag" legal due diligence report on the target. This is simply an economic (cash-saving) approach, allowing the fund to show interest and get to know the target more intimately without "burning cash" on what may turn out to be an uninteresting or too costly object. If the fund is invited into the final bid round of an "auction" process, and provided only few bidders remain in contest, the diligence field is opened up, and PE funds normally ask its advisors to prepare a more complete diligence report on legal, financial, commercial and compliance matters. Further, on compliance diligence, see question 10.4. The level of scope, materiality, etc. will depend on certain associated factors, like whether the fund has obtained exclusivity, whether the target is reputable or otherwise familiar to the investors, the equity, debt and liability history of the target, the prevailing M&A market (to some extent, the warranty catalogue reflects the diligence process), and so forth.

PE funds normally always engage outside expertise to conduct diligence in connection with LBO-transactions. This will normally also be a requirement from the senior banks in order to finance such transactions. Even if the fund has in-house counsel, outside expertise is engaged so that the fund's investment committee can make informed decisions on the basis of impartial, qualified and independent advice.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

In our experience, particular Pan-European and global funds have, in the last few years, increased their focus on and concerns about regulatory and compliance risk in their diligence exercises. For some of these funds, it has become standard to request legal advisors to prepare separate anti-bribery reports to supplement the regular diligence report, often also accompanied by a separate environmental, social and governance ("**ESG**") report. Some of the funds also require that the sellers provide separate anti-corruption and anti-bribery warranties in the SPA.

Previously, Norwegian funds were more relaxed and it was not market practice to request such special reports. Now, this seems to slowly change, and on the diligence side we see a continuing focus on legal compliance because regulators in general have become more aggressive in pursuing enforcement of bribery, corruption and money laundering laws.

From a contractual (SPA) point of view, it should also be noted that providers of W&I insurance normally, probably by virtue of great damage potential and the inherent difficulty (impossibility) of examining facts through its own underwriting process, will, with some exemptions, refuse coverage for any seller warranties assuring compliance with and absence of anti-corruptive behaviours. As can be expected, this creates a disharmony in PE due diligence (*cf.* above) and the concurrent or ensuing SPA negotiations, where both parties (in principle) are open for relevant representations and warranties in relation to anti-bribery/anti-corruption being included, but where the vendor cannot abide for the sake of a clean exit (which the buyer reluctantly can appreciate).

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

The general rule under Norwegian law is corporate personhood, whereby a portfolio company alone is held accountable/liable for its own acts and omissions – i.e. a Norwegian court of competent jurisdiction will only pierce the corporate veil in exceptional circumstances.

From this general point of basis flows certain limited, but important exceptions, namely that a parent company or a controlling shareholder may be held independently liable for its subsidiary's liability if it has contributed to a wrongful act through a controlling interest in the company (see question 3.6). For practical purposes, such liability can be divided into "criminal liabilities" and "civil liabilities".

In the criminal liabilities category falls anything that a portfolio company may do or refrain from doing, which carries the potential risk of criminal prosecution. In respect of publicly listed companies, and thus relevant in relation to IPO exits or *public-to-private* transactions, such "criminal liability" may arise in connection with *market manipulation* (undertaken in order to artificially inflate or deflate the trading price of listed shares), *insider dealing* or *violation of relevant security trading regulations* (e.g. wilful misrepresentation or omission of certain information in offer documents). If a portfolio company violates such regulations, and its PE investor (either on its own, through the violating portfolio company or through another portfolio company) transacts in securities affected thereby, there is a tangible risk that the PE investor will be identified with its portfolio company (i.e. the shareholder *should have known*), and thus held liable for the same transgression(s).

In the category of "civil liability" (meaning that liability usually is limited to fines or private lawsuits), the same consolidation (identification) rules may come to play if a portfolio company violates, e.g. applicable antitrust or environmental legislation. Over recent years, we have seen very few, but disturbing, examples of decisions by Norwegian courts in which it was ruled that environmental liability of a subsidiary (unable to remedy the situation on its own) was moved upwards in the holding structure until rectification was satisfied.

The foregoing notwithstanding, the general concept of corporate personhood and individual (contained) liability is still the all-encompassing rule of practice, and we have yet to see any case where a PE investor or another portfolio company has been held liable for its portfolio company acts or omissions in Norway.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Tax treatment of management fee paid by private equity fund to its managers

In a ruling by the Norwegian Supreme Court from February 2018, the court concluded that management fees paid by a PE fund to its manager/advisor must, for tax purposes, be allocated between the

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different tasks carried out by such managers on behalf of the fund. In this regard, the Supreme Court concludes that any part of such management fees that could be considered related to transaction services (i.e. services related to acquisitions and exits of the funds' portfolio companies) carried out by a fund's managers, under Norwegian law, must be capitalised and consequently will not be tax-deductible for such funds. In this particular case, the Norwegian tax authorities had argued that 40% of the management fee was related to such transaction services. However, the court concluded that this was not sufficiently considered and justified, thus resolving to set aside the tax assessment. This ruling will mainly have an impact on investors domiciled in Norway investing into PE funds organised as limited partnerships, since the profit and losses from such limited partnerships under Norwegian law must be allocated among its partners and will be taxed at the hand of such partners.

VAT

On 16 May 2013, the Norwegian tax authorities issued a much-criticised memo in which the authorities argued that in the event a Sponsor provides advisory and consultancy services to its portfolio companies, such services should be subject to 25% VAT. This raises difficult classification issues between the Sponsor's ordinary management of its portfolio companies which, in general, is VAT-exempt, and other consultancy/advisory services that may be subject to VAT. The authorities have indicated that individual circumstances in a tax inspection may determine that parts of the management services provided by a Sponsor must be reclassified as consultancy services and therefore will become subject to VAT under Norwegian law. There has also been an increased aggressiveness from the authorities on this area and we expect that this will continue in the coming year.

EU initiatives

Over the last few years, the EU has issued several new Directives, regulations and/or clarification statements regarding the capital markets. These initiatives from the EU, will most likely, directly or indirectly, have an impact on the regulatory framework for public M&A transactions in Norway in the years to come. As a result of these initiatives, the Norwegian government has appointed an expert committee to evaluate and propose relevant amendments to the existing Norwegian legislation resulting from EU amending the Transparency Directive, the MIFID I, and the Market Abuse Directive. This committee has now published five reports proposing several amendments to the STA.

New Takeover Rules expected

In addition, a committee is currently also working on a report concerning the Norwegian rules governing voluntary and mandatory offers, with a particular focus on the STA current limited regulation of the pre-offer phase. This committee report does not arise out of changes to EU rules but rather the need to review and update Norwegian takeover rules on the basis of past experience and market developments. On 23 January 2019, the committee has now also submitted a report concerning the Norwegian rules on voluntary and mandatory offers, with particular focus on the current limited regulation of the pre-offer phase. It is currently unclear when Parliament can be expected to adopt these amendments into Norwegian legislation. However, we do not expect the proposed changes to be implemented into Norwegian law until 1 January 2020 at the earliest.

Proposed amendments to the Norwegian Companies legislation

In early 2019, the Norwegian Ministry of Industry, Trade and Fishery issued certain proposals to amend the rules of the Norwegian Companies Acts in order to implement EU directive (EU) 2017/828 into Norwegian law. In addition, certain amendments are proposed with regard to transactions between a company and its related parties and also in relation to a company's ability to provide financial assistance to its shareholders, etc. Even though most of these amendments are not aimed at M&A specifically, some could have an impact both on the structuring and the financing (and on the financing structures) of M&A transactions. One such new rule, is the Ministry's revised proposal for abolishing the requirement that a buyer (borrower) must deposit "adequate security" towards the target company if such buyer receives any form of financial assistance from the target in the form of security for the buyer's acquisition financing. If this proposal is adopted by Parliament in its current form, it looks as if Norway, in the near future, will have also implemented a type of "whitewash procedure" that could also work for LBO transactions.

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Portugal

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

Private equity in Portugal has experienced significant growth despite the financial crisis and sovereign debt crisis, which have loomed over the country in the last few years. According to the latest data available (the Portuguese Securities Market Commission – "CMVM", 2017), value under management by private equity players has been steadily rising since 2003, reaching €4.8 billion by the end of 2017.

Turnaround or distressed transactions have been the most relevant types of private equity deals in Portugal in the last few years, followed by growth capital investment. Nevertheless, venture capital (start-up, seed and early-stage) investing and management buyouts have maintained their relevance throughout 2017.

Other recent trends in the Portuguese market include: (i) the award of European structural and investment funds to capitalise SMEs; (ii) the emergence of in-house venture capital units in large Portuguese corporations, which do early- and mid-stage investments in seed and start-up companies; and (iii) following recent changes in immigration law, the incorporation of private equity funds specifically structured for non-EEA residents to obtain investment residence permits.

With regards to sector allocation of investments, in 2017 real estate, hospitality, manufacturing and information technologies took the lead.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

The search for yield by investors, as the ECB continues its accommodative monetary policy, still plays an important role in the demand for private equity transactions (notably those concerning infrastructure assets).

Also, as mentioned in the previous question, (i) the launching of public tenders by State-owned entities to capitalise companies, such as tenders to award European Union funds to entities organised as private equity fund managers, and (ii) the use of private equity funds as conduits for obtaining investment residence permits, are also encouraging fundraising and consequently, private equity and venture capital transactions in Portugal.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

For the next 12 months, we expect to continue to see strong numbers in venture capital transactions given the relevance of European structural funds and the success acquired by Lisbon as a start-up hub.

In the longer term, our supposition is that with the end of the first large private equity "investment cycle" in Portugal, many funds will need to be unwound, generating significant volume in transactions with private equity on the sell-side; management entities on the other hand will need to explore new strategies to stay profitable, especially large ones which traditionally focused on turnaround investments.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

The typical private equity transaction in Portugal is made through a private equity fund. Pursuant to this structure, the fund participants or LPs (as well as the managing entity, which retains some "skin in the game") subscribe and pay-up units in the fund, after the latter is registered before the relevant regulatory authority in Portugal (CMVM).

The aforementioned investment vehicles then either: (i) acquire equity participations directly or through a wholly owned "BidCo" or subscribe newly issued shares by the target company (in a typical buyout, growth or venture capital deal); or (ii) acquire debt instruments or securities (notably senior bank loans) and convert such instruments into equity, thereby gaining control of the target (in distressed or turnaround transactions).

If the private equity investor does not ultimately come to hold the entirety of the company's equity, a shareholder agreement is generally entered into with the surviving shareholders.

2.2 What are the main drivers for these acquisition structures?

The main drivers for these structures relate to incentive alignment and tax reasons.

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Investment using private equity funds is an efficient way for various institutional investors to pool money into alternative asset classes which potentially offer higher yields than public equities or bonds, while avoiding operational risks and regulatory hurdles which would arise from investing directly in non-listed companies. In private equity funds, the managing entity retains a residual equity participation in the fund to signal that it is committed to act in the best interests of the LPs. The carried interest remuneration structure (detailed below) also helps align incentives.

Tax-wise, private equity funds incorporated in Portugal are exempt from corporate income tax and any gains made are directly attributed to its LPs, at a favourable rate.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

Usually the equity is divided in share classes and quasi-equity shareholder contributions with the private equity investor subscribing the latter as well as preferred shares, granting the latter special "political rights" and preference in liquidation.

Management, on the other hand, will typically own common shares and be the recipient of an incentive plan, which may or may not include the attribution of additional "physical" equity instruments (alternatives include phantom shares or performance-based cash pay-outs).

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Besides the capital structure being markedly different, in minority investments (notably in venture capital transactions) the private equity investor usually requests veto rights in shareholder and board decisions, anti-dilution provisions and pre-emption/tag-along rights.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Equity attributable to management in majority acquisitions may vary considerably, from single digits to a sizeable minority participation.

Vesting usually occurs during a three to four-year period, with the period being structured with a one-year cliff and "linear" vesting thereafter.

Compulsory acquisition provisions essentially depend on the mode of management departure: (i) if management are deemed a "bad leaver", unvested shares are acquired at nominal value; or (ii) if, alternatively, the management are considered "good leaver", shares are acquired at fair value.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

A manager will be treated as a good leaver if private equity investors deem it so or, alternatively, if the former requires to leave the company for serious reasons unrelated to professional factors (illness, serious injury, attending to family members).

In investor-friendly deals, the "bad leaver" concept is usually defined by exclusion, meaning that a manager will be deemed a bad leaver towards the company unless it is determined that it has parted ways with the same in a manner which would allow her to be considered a "good leaver".

In more manager/founder-friendly transactions, the bad leaver definition often contains a "discrete" set of premises (for instance, resigning at own volition from board functions before a certain date, being dismissed with cause from board functions).

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

Private equity investors will commonly have one or more representatives on the board of directors of portfolio companies to serve as non-executive directors. Another typical feature of governance structures of (the larger) portfolio companies is the set-up of a remuneration committee and/or related party transactions committee used for the private equity investor to monitor the company.

These governance arrangements are typically regulated in a shareholder agreement. Such agreements, unless they relate to public (i.e. which shares are exchanged in a regulated market) or financial companies, need not be made public and will almost surely contain confidentiality provisions.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Yes. Usually shareholder agreements entered into between private equity investors and management/surviving shareholders/partnering shareholders will have "restricted matters" at board of directors and shareholder level (via supermajorities or share classes) involving material aspects of the business regarding which the private equity investor enjoys a veto right.

Veto rights enjoyed by private equity investors in portfolio companies at shareholder level typically include fundamental corporate matters such as amendments to articles of association, mergers, demergers, approval of annual accounts and distributions. "Restricted matters" at board level are more managerial in nature and include relevant expansions or divestments in the business, approvals of business plans and dealings with related parties.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

No limitations usually exist. Restricted board matters are, almost without exception, transposed into the company's by-laws, making them enforceable towards third parties.

Similarly, on matters where shareholders have the last say (which would depend on the type of company in question), the shareholders' agreement and by-laws create a set of restricted matters (again supermajorities or share classes) for shareholders' resolutions as well, granting a veto right to the private equity investor.

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3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

No special statutory duties exist regarding private equity investors in relation to minority shareholders or otherwise. It is argued that there are, in any case, general corporate law duties which should be observed by shareholders (towards other shareholders and the company) such as duties of loyalty.

It is also worth noting that Portuguese law provides for several special rights of minority shareholders, such as the right to appoint directors from a separate list (if such mechanism is included in the by-laws) or the right to annul resolutions approved by the majority shareholders, if proved to be to their detriment (e.g. on self-dealing transactions). In addition, the law provides for "opt-out" rights for minority shareholders in case of (i) mergers and demergers (when minority shareholders vote against such transactions), and (ii) in case there is a majority shareholder holding more than 90% of the share capital in the company.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Under Portuguese law, it is generally understood that the provisions of shareholder agreements are binding only upon the parties and, thus, are not enforceable towards third parties, nor towards the company itself.

Other restrictions set out in the law regarding the contents of shareholder agreements include: (i) no provisions may be included restricting the actions of members of the company's management or audit bodies; (ii) no shareholder may commit to always vote in accordance with the instructions or proposals given/made by the company or its management or audit bodies; and (iii) no shareholder may exercise or not exercise its voting right in exchange for "special advantages" (i.e. prohibition of vote selling).

Regarding: (i) governing law and jurisdiction of shareholder agreements, no particular restrictions exist (although any shareholder agreements regarding Portuguese companies should respect the restrictions set out in the previous paragraph as well as other mandatory Portuguese law provisions); and (ii) non-compete provisions, these should be weighed against mandatory labour and competition law provisions to assess their validity.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

As a general rule, legal persons are entitled to appoint persons to, on their behalf, exercise functions as directors.

Concretely, directors appointed by private equity investors should be aware that, under Portuguese law, they owe fiduciary duties (care and loyalty) to all shareholders of the portfolio company and may not cater only to the interests of the private equity investor.

On the other hand, private equity investors, if they exercise a significant influence in the company to allow it to be qualified as a *de facto* board member, may be held liable should the company be declared insolvent if it is proven that the insolvency was the result of culpable action by the investor.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

At fund level, conflicts of interest are typically addressed through an Advisory Council, of which attributions typically entail issuing opinions on certain transactions undertaken by the fund, notably related-party transactions, and other conflicts of interest.

At portfolio company level, a related-party transaction committee is often set up to deal with vertical (company-fund) and horizontal (portfolio company-portfolio company) conflicts of interest.

More generally, statutory corporate law provisions contain mandatory provisions whereby shareholders and board members are impeded to vote in the relevant meetings if they are deemed to be in a conflict of interest.

Agreements implementing the investment often attempt to regulate conflicts of interests which arise from private equity management having directorships in several portfolio companies (usually by providing protections to the private equity investor).

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

Timetable constraints and other formalities for transactions in Portugal generally involve the following:

a) waivers from financing banks, in direct or, sometimes, indirect changes of control;
b) securing financing for the transaction;
c) in asset deals (e.g. transfer of business via agreement or prior statutory demerger), formalities related to employment matters, notably town hall meetings and opinions from employees' representative structures;
d) waivers from competition authorities; and
e) deals in some regulated sectors (especially banks, insurance companies and other financial institutions) require prior approval from the respective regulatory authorities.

4.2 Have there been any discernible trends in transaction terms over recent years?

In recent years, "locked-box" price adjustment mechanisms have become more common in transactions.

In addition, warranties and indemnities insurance policies are slowly being introduced in the Portuguese market, notably where private equity sellers are involved.

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5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Only one private equity type public-to-private transaction has ever been recorded in Portugal (i.e. the acquisition of Brisa, a highway toll operator, in 2012, by a joint venture formed by a Portuguese family office holding company and a European infrastructure fund).

Since there is but one example of this type of transaction in Portugal, it is not possible to assess patterns or trends.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

See the answer to question 5.1 above. There are, however, recommendations in the Corporate Governance Code applicable to Portuguese listed companies which advise against the adoption of break fees or similar pay-outs in public tender offers.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

Common variations to the price payable by private equity investors in Portugal to shareholders of portfolio companies include: (i) deduction of the amount corresponding to non-current net debt; and (ii) when relevant, accrual of net working capital. This structure is usually preferred by private equity investors acting on the buy-side.

On the other hand, "locked-box" consideration structures are increasingly being used (more prevalent on the sell-side).

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

Standard representations and warranties involving mostly the underlying assets of the portfolio companies (as opposed to management) are offered. Especially in more "buyer-friendly" deals, specific indemnities (notably tax indemnities) are also included.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Covenants and other undertakings usually include non-compete provisions. Asset-specific covenants are also provided, when applicable.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Warranty and indemnity insurance was scarcely used but is now more common in transactions involving private equity sellers.

Typical exclusions include: criminal liability; certain tax matters; fraud; and matters known to the buyer during due diligence.

The insurance premium is usually calculated as a percentage of the liability cap.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Caps and baskets are the most usual limitations to liability in private equity exit transactions. Specific disclosures against warranties (typically included in disclosure letters) are also commonly used.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Private equity sellers, especially ones backed by funds reaching maturity, prefer to shy away from providing securities for breach of representations and warranties but may occasionally provide escrow account/price retention mechanisms to the benefit buyers.

Private equity buyers, on the other hand, are keener (and it occurs frequently) on having escrow accounts with part of the price.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Corporate guarantees/comfort letters are common. To a limited extent, bank guarantees are also provided.

In case of non-performance of funding obligations, the seller's typical remedy is to claim for damages.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are not common.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

No private equity investment has ever generated an exit involving a listing in Portugal.

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7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

As mentioned above, there is no factual basis to answer the question as no IPO exit from a private equity investment has ever been made.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

We are not aware of any dual-track process for the sale of a private equity portfolio company ever being initiated in Portugal.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Due to the fact that the average value of private equity transactions in Portugal is small, deals involving private equity investors are made almost exclusively through the funds' equity, raised from its unit holders. Debt financing of transactions is thus rare and the issuance of high-yield bonds even more so.

When it does occur (in larger transactions), debt financing of private equity transactions is usually made through senior secured loan facilities (usually composed of an acquisition facility and a revolving facility). Bond issuances are rare in private equity acquisition finance and the few issuances which exist are subscribed by banking syndicates.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

Notwithstanding the above-mentioned response, it is worth noting that financial assistance (i.e. contracting loans or providing securities for the acquisition of the company's own shares) is restricted under Portuguese law, thus limiting the possibility of pursuing leveraged buyouts.

When planning raising debt financing, "interest stripping" rules under Portuguese law which limit the deductibility of financial expenses, should also be taken into account.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

Due in part to a blooming real estate market in large Portuguese urban centres, as well as to the continuance of low interest rates, debt financing activity (acquisition finance, project finance) has risen in recent years.

This debt is being syndicated increasingly by foreign banks as Portuguese banks are still improving their balance sheets following the sovereign debt crisis and ensuing recapitalisation measures.

Finally, in recent times there have been various refinancing transactions as a consequence of diminishing rates and increasing borrower credit profiles.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Private equity funds are considered neutral vehicles, for tax purposes, and as such are exempt from corporate income tax. Income derived by the unit holders in the private equity funds, on the other hand, is subject to a 10% withholding tax (whether personal or corporate income tax), provided the unit holder is a non-resident entity (without permanent establishment in Portugal), or an individual resident in Portugal (that derives this income out of a business activity).

If the unit holder in the private equity fund (i.e. when the beneficiary of such income) is an entity exempted from tax on capital gains (resident or non-resident) or if they are an entity with no permanent establishment in Portugal to which the income is attributable, the derived income may be exempted from tax in Portugal.

Neither the 10% or the exemption rule are applicable when: (i) the beneficiary is an entity resident in a blacklisted jurisdiction; and (ii) when the beneficiaries are non-resident entities held, directly or indirectly (more than 25%), by resident entities. The general withholding tax is 35% in the case of blacklisted entities; in other cases, there is 25% corporate income tax ("CIT") withholding tax.

Offshore structures are not common owing mostly to the disadvantageous tax repercussions of setting up transactions in blacklisted entities (see paragraph above). Nevertheless, international fund managers usually invest through Luxembourg vehicles (typically then incorporating a Portuguese BidCo to execute the transaction).

Private equity companies (*sociedades de capital de risco*) also benefit from a tax allowance of a sum corresponding to the limit of the sum of the tax base of the five preceding years, as long as such deduction is used to invest in companies with high growth potential. On the other hand, dividends payable by private equity companies to its shareholders do not receive any special treatment (i.e. 28% final rate for individuals and the current corporate income tax rates for companies).

Capital gains derived by the sale of units in the private equity funds are subject to 10% CIT and personal income tax ("PIT") if the resident entity derives the income out of a business activity and, regarding the non-resident entity, if it is not exempted under the general exemption on capital gains obtained by non-residents.

Alas, the treatment of income derived from carried interest and other variable private equity managers' compensation is not clear from tax legislation. As such, due to the fact that, from a tax perspective, treatment of such income is not clear, there have been several calls to, as in many other jurisdictions, clearly state that variable management compensation is taxed as capital gains.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Tax considerations invariably play a role in structuring management

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compensation packages, whether they are in a form of physical shares, "phantom" shares or earn-outs, but there is no one typical tax-efficient arrangement to remunerate management in private equity transactions.

It is worth mentioning, however, that the 2018 State Budget includes a tax benefit that foresees the exemption for PIT of gains arising from stock option plans up to the amount of €40,000 received by the start-ups/emerging companies' employees.

For this tax exemption to apply:

- Employers must qualify as micro or small enterprises and have developed their activities for a period not longer than six years within the technological sector.
- Employees must own the relevant stocks for at least two years, not be a member of any corporate body and not hold a participation higher than 5% in the respective company.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

A tax neutrality regime on the corporate reorganisations is also available, allowing for cases of merger, de-merger, and/or asset contribution, in order that no step up in value is realised, but at the same time preserving the original date of acquisition of the participations.

Additionally, there are two key tax considerations: the participation exemption regime; and the tax treatment of dividends distributed by a Portuguese company.

The Portuguese Participation Exemption regime currently in force foresees that dividends distributed by a company resident in Portugal (and not subject to the tax transparency regime) to its corporate shareholder are tax-exempt, provided some requirements are met, such as a continuous 12-month holding period of at least 10% of the shares or voting rights.

Under the outbound regime, to benefit from the 0% withholding tax rate on the dividends paid by a company in Portugal, besides the fact that the beneficiary of the income has to be subject in its residence State to a CIT nominal tax rate of at least 12.6%, it has to hold, directly or indirectly, at least a 10% stake in the company resident in Portugal uninterruptedly held in the 12 months prior to the distribution of dividends.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

A recent change in the law has caused Portuguese tax authorities to consider management fees charged by management entities to funds as being subject to stamp duty (*imposto do selo*). This interpretation does not appear to be, however, unanimous and it may face challenges from taxpayers in the future.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

Law no. 16/2015 and Law no. 18/2015 provided several major changes to the regulation of private equity in Portugal. Highlights include:

a) Investment compartments – the management regulations of private equity or venture capital funds may now establish that the fund may be divided into several investment compartments, named "subfunds".

b) Management may change certain aspects of the management regulations (e.g. details of the manager and reduction in management fees) in private equity funds without the consent of unit holders.

c) Own funds requirements – private equity and venture capital companies must have their own funds corresponding to 0.02% of the amount of the net value of assets under management exceeding €250 million.

However, the main innovation put in place by the enactment of Law no. 18/2015 is imposing a more demanding regulatory framework to management entities of collective undertakings which have assets under management with a value exceeding: (i) €100 million, when the respective portfolios include assets acquired with leverage; or (ii) €500 million, when the respective portfolios do not include assets acquired through leverage and regarding which there are no reimbursement rights which may be exercised during a five-year period counting from the date of initial investment.

Such funds are now subject to, *inter alia*, the following obligations:

a) their incorporation is subject to the prior authorisation of CMVM;

b) risk management should be functionally and hierarchically separated from the operating units, including the portfolio management function;

c) measures should be taken to identify situations of possible conflicts of interest as well as to prevent, manage and monitor conflicts of interest;

d) CMVM shall be informed of the intention to delegate services to third parties for carrying out functions in the name of the above-mentioned managing entities;

e) managing entities shall employ an appropriate liquidity management system; and

f) applicability of "EU passport rules" (i.e. the ability to market units of private equity funds in other EU countries or third countries).

Also worth noting, is the new crowdfunding legislation, which provides a framework for the creation of equity crowdfunding platforms in Portugal, which is becoming increasingly relevant for venture capital investment in the Portuguese market.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

There is no enhanced scrutiny of private equity transactions in Portugal. In any case, certain rules exist which apply to foreign investment controls in critical infrastructure.

Under the provisions of Decree-Law no. 138/2014, of September 15, acquisitions of control of critical infrastructure by non-EEA

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residents may be subject to review by the Portuguese government. Transactions which have not been previously cleared and are subject to opposition by the government are null and void.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

Private equity investors usually undertake legal due diligence before investing in a company. Timeframes for conducting due diligence range from one to three months and will typically have materiality thresholds for litigation and material agreements under review. Often, insurance, competition and tax matters will be excluded from due diligence (sometimes because other advisors will be engaged to perform the review in such matters).

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Law no. 83/2017, of August 18 (which partially transposes the 5th Money Laundering Directive to the Portuguese jurisdiction), establishes several obligations on, among others, "know your customer" and due diligence procedures and disclosure of monetary flows for purposes of preventing money laundering transactions and the financing of terrorism. These obligations are applicable to private equity fund managers (as well as to banks and other financial institutions).

The aforementioned reporting duties have an impact on due diligence procedures taken during fund structuring, as the private equity investor shall, for instance, be obliged to know what the controlling structure of its clients is (the fund LPs) and who the ultimate beneficial owner of such LPs is. Consequently, the major private equity players in Portugal have instated official "know your customer" procedures in an effort to not fall foul of the law's provisions.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Private equity funds enjoy full limited liability and asset partitioning in relation to its portfolio companies and participants, respectively. In this sense, the fund may not be liable for debts and other liabilities of the portfolio companies, unless it has provided guarantees for the benefit of such companies.

As for private equity companies, if the latter holds 100% of the share capital of a portfolio company incorporated in Portugal, mandatory corporate law provisions assume a "co-mingling of assets" of sorts and state that they are jointly and severally liable before the creditors of said portfolio companies (following a 30-day delay in performance of the obligation in question).

In the case of portfolio companies being liable before one another, assuming that they are both directly held by the same private equity investor (i.e. horizontal group relationship), no subsidiary liability may arise.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Portugal has been establishing itself to both inside and outside investors as a "business"- and "transaction"-friendly jurisdiction. This is also reflected in the private equity sector.

Alas, some challenges remain, notably concerning timings for the resolution of disputes in the State courts (which is why transaction agreements usually contain arbitration clauses).

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Morais Leitão, Galvão Teles, Soares da Silva & Associados (Morais Leitão) is a leading full-service law firm in Portugal, with a solid background of decades of experience. Broadly recognised, Morais Leitão is referenced in several branches and sectors of the law on national and international level.

The firm's reputation amongst both peers and clients stems from the excellence of the legal services provided. The firm's work is characterised by unique technical expertise, combined with a distinctive approach and cutting-edge solutions that often challenge some of the most conventional practices.

With a team comprising over 250 lawyers at a client's disposal, Morais Leitão is headquartered in Lisbon with additional offices in Porto and Funchal. Due to its network of associations and alliances with local firms and the creation of the Morais Leitão Legal Circle in 2010, the firm can also offer support through offices in Angola (ALC Advogados), Hong Kong and Macau (MdME Lawyers), and Mozambique (HRA Advogados).

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Singapore

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

The most common types of private equity transactions in Singapore are venture capital, buyout transactions, and minority investments in portfolio companies.

The volume of private equity activity in Singapore remained strong in 2018, with the technology and real estate sectors continuing to generate keen interest. FinTech, in particular, has generated much attention in the last two to three years. Noteworthy private equity transactions include Grab Holdings, which raised US$2 billion in its 2018 funding round with Toyota Motor Corp and other investors, Bain Capital Private Equity's acquisition of Singapore-headquartered DSM Sinochem Pharmaceuticals for US$582 million, Allianz' acquisition of a minority stake in Ocean Financial Centre for US$392 million and Standard Chartered Private Equity's privatisation of crane supplier Tat Hong Holdings for US$302 million.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Singapore is one of the most developed markets in South-east Asia, with a stable political-economic environment, strong infrastructure and stable regulatory environment, investor-friendly tax regime and skilled workforce with a strong pool of professional talent. The Monetary Authority of Singapore (MAS) fosters growth in private market financing and the asset management industry with a view to promoting Singapore as the leading financing centre in the region. These factors continue to draw private equity investors, as Singapore provides a good base from which to make investments in the region.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

Over the next 12 months, we expect private equity sentiment to remain upbeat as there continues to be sustained investor interest in the region. We anticipate continued growth of the MAS's external fund manager programme which attracts and supports global asset managers in the public markets space to anchor in Singapore.

In late 2018, the MAS announced an incentive programme that will place up to US$5 billion for management with private equity and infrastructure fund managers. MAS has also pledged to work with private market funding platforms in order to connect growth companies to the broader investor network. Longer term, we expect to see increased development of the private markets financing channels.

The Singapore Academy of Law and Singapore Venture Capital and Private Equity Association have also worked together to develop and launch a set of model agreements for use in seed rounds and early stage financing, called the Venture Capital Investment Model Agreements (VIMA), with the aim of cutting down transaction costs and reducing friction during the negotiation process.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Private equity investments are typically structured with an off-shore holding company whose shares are held by the private equity investor and management. A BidCo is sometimes used under the holding company to hold the target's shares and/or to take on acquisition debt.

2.2 What are the main drivers for these acquisition structures?

The main drivers for these acquisition structures are tax efficiency and financing requirements.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

Private equity investors typically invest through a combination of ordinary and/or preference equity and convertible debt, with the latter two forming the bulk of the investment.

Key management may be granted equity sweeteners whose structures can vary substantially – from ordinary shares with a vesting schedule and profit participating options exercisable on exit, to subordinated equity.

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2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

The key considerations when taking minority positions are governance (as specified in section 3 below) and the need to ensure preferred returns. Minority investments by private equity investors usually take the form of convertible or mezzanine debt (to maintain priority) or preferred shares.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

The typical range of equity allocated to management is 10% to 20%. Management equity typically vests over three to five years, or upon an exit. Management equity is usually subject to (a) "good leaver" and "bad leaver" provisions under which such equity may be acquired at either fair value or at cost, and (b) a drag-along right in the event of an exit by the private equity investor.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Persons who leave due to death or disability will usually be treated as good leavers and persons who are dismissed for cause or in other circumstances justifying summary dismissal will usually be treated as bad leavers.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

The governance arrangements of private equity portfolio companies with more than one shareholder are usually set out in a shareholders' agreement. Typical arrangements include veto rights, restrictions on the transfer of securities, covenants on the continued operation of business, non-compete undertakings and deadlock resolution procedures.

Some of the arrangements will also be set out in the portfolio company's constitution, which is made available to the public upon filing with the Accounting and Corporate Regulatory Authority (ACRA). Shareholders' agreements are, however, not required to be filed with ACRA and are generally not required to be made publicly available unless they contain arrangements entered into as part of a take-private transaction governed by the Singapore Takeover Code.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Yes, private equity investors typically enjoy veto rights over material corporate actions. Typical veto rights enjoyed by private equity investors include restrictions on further issuances of debt/equity, change of business, winding-up and related party transactions. Depending on the size of the minority stake, the private equity investor may also have veto rights over operational matters such as the annual budget and business plan, capital expenditures above a certain threshold and material acquisitions and disposals.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

Singapore courts will generally enforce veto arrangements at both the shareholder level and board level. However, veto rights exercised by directors are subject to their overriding fiduciary duty to the company on whose board they sit. Where there is a concern that the directors' ability to exercise their veto rights may be limited by their fiduciary duty owed to the company, such concern is often addressed by giving such veto rights to the shareholders instead of the directors.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

A private equity investor does not owe any duty to minority shareholders such as management shareholders (or *vice versa*). However, minority shareholders can seek recourse under Section 216 of the Companies Act if the affairs of a Singapore company are conducted in a manner which is oppressive to one or more minority shareholders. If a finding of oppression is made, the court may order such remedies as it deems fit, including orders regulating the future conduct of the company or a winding-up.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Singapore courts generally uphold the provisions of a shareholder agreement in relation to a Singapore company, except for those provisions which are unlawful or otherwise regarded as contrary to public policy.

Non-compete and non-solicit provisions are regarded as a restraint on trade and against public policy. These are unenforceable unless the party seeking enforcement can show that the restraint is reasonable and seeks to protect a legitimate proprietary interest.

Provisions that are regarded as penal in nature will also be struck down.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

Singapore companies require at least one Singapore-resident director. Certain persons (e.g. an undischarged bankrupt or a person who has been convicted for offences relating to fraud or dishonesty)

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are not eligible to be directors of a Singapore company. Directors of Singapore companies have duties under the Companies Act *vis-à-vis* the Singapore company. These include obligations to disclose their interests in transactions with the company (Section 156 of the Companies Act), an obligation to seek authorisation from the company prior to disclosing information received in their capacity as directors (Section 158 of the Companies Act) and a duty to act at all times honestly and with reasonable diligence in the discharge of its duties (Section 157 of the Companies Act). Such directors also owe a common law fiduciary duty to the company. These obligations apply not only to persons formally appointed as directors of the company, but also to any person whom the court considers a "shadow director" (usually a person whose directions or instructions an appointed director is accustomed to act upon).

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Directors who face a conflict of interests (whether actual or potential) should disclose the nature of the conflict to the board and abstain from voting on the resolution. Private equity investors should craft their veto rights accordingly so that the investor, as a shareholder, has the ability to ensure that certain decisions cannot be taken without their consent even if their directors have to abstain from voting.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

For public-to-private transactions, the key drivers of the timetable are the mandatory timelines imposed by the Singapore Takeover Code and the clearances required from the Securities Industry Council prior to announcing the transaction. Privatisation transactions subject to the Singapore Takeover Code generally take between two to three months to complete, assuming no other regulatory clearances are required. Where the privatisation is subject to shareholders' approval, the timetable will be stretched by an additional five to seven weeks to include the time needed for clearance by the Singapore Exchange and the notice period for the shareholders' meeting. As public-to-private transactions are subject to certain funding requirements prior to launching the transaction, the time needed to satisfy this requirement should also be taken into account.

Other factors that may affect the timetable for transactions include the scope of due diligence (including the preparation of financials for the purposes of locked-box deals) and other regulatory approvals. Key regulatory approvals that may materially affect the timeline include industry-specific approvals in relation to holdings in regulated industries (e.g. banking, insurance, telecommunications, etc.) and competition clearances. The timeframe for competition clearance is approximately 30 working days (in respect of a Phase 1 review) and 120 working days (in respect of a Phase 2 review).

4.2 Have there been any discernible trends in transaction terms over recent years?

Recent trends in private equity transactions include the use of warranty and indemnity insurance and the introduction of locked-box structures *in lieu* of purchase price adjustment mechanisms for debt and/or working capital as at the closing date.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Public-to-private transactions are governed by the Singapore Takeover Code, which imposes certain rules and restrictions which have a significant impact on deal structuring. A firm intention to make a public takeover, once announced, cannot be subject to, or conditional upon, financing being obtained. This certain funds' requirement means that deal financing must be in place at the time of announcement, with limited covenants under which the financing can be withdrawn.

The Singapore Takeover Code's requirement for all shareholders to be treated equally also limits the ability of private equity investors to offer sweeteners to key shareholders, and this often results in higher acquisition costs for public-to-private transactions.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

Deal protections available to private equity investors in Singapore in relation to public acquisitions include break fees (levied on a target company) and reverse break fees (levied on an offeror). Where a break fee is imposed, the Singapore Takeover Code requires that it be no more than 1% of the value of the offeree company and confirmations must be made by the board of the offeree company and its financial adviser that break fee provisions were agreed upon during ordinary commercial negotiations and are in the best interests of shareholders; if a break fee has been assessed as a penalty as opposed to a pre-estimate of a loss, it will not be enforceable. While break fees are permitted under the Singapore Takeover Code, they are not commonly used.

Deal protections on the buy-side include no-shop or exclusivity clauses which limit the seller's ability to actively pursue other buyers for a specified period of time. On the sell-side, standstill clauses protect the seller's ability to control the sale process by preventing potential purchasers from acquiring a stake other than via the negotiated deal with the seller.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

Private equity investors on the sell-side tend to prefer all cash consideration structures that are subject to adjustments based on completion accounts to be prepared post-completion (typically to adjust for working capital levels). Locked-box structures are sometimes used but are less common.

Buy-side private equity investors also tend to prefer all cash consideration structures, and typically require an escrow amount to

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be set aside for warranty claims. Earn-out payments or profit guarantees are also preferred mechanisms to bridge valuation gaps.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

Private equity sellers would typically seek to limit their warranties and/or indemnities to warranties on title, capacity and authority.

Where management holds a significant stake, they are expected to give comprehensive warranties to the buyer, together with a management representation made to the private equity sellers.

Where the management stake is not significant, the private equity sellers may be prepared to increase the scope of warranties subject to limited liability caps of between 10% to 25% of the consideration.

Warranty and indemnity insurance is also gaining popularity as a way to bridge the liability gaps (see question 6.4 below).

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Private equity sellers typically agree to a set of undertakings as to the conduct of business pre-completion in order to ensure the business is carried on in the ordinary course and to minimise any value leakage. Non-competes or non-solicits are generally not given by the private equity seller, though these would be given by the management team.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Warranty and indemnity insurance is gaining popularity among private equity investors. It is used on the sell-side to bridge the gap on liability caps and on the buy-side to improve the attractiveness of the private equity investor's bid in competitive bid situations.

Typical excesses range from 0.5% to 1% of the insured amount and typical policy limits range from 20% to 30% of the insured amount. Customary carve outs/exclusions include known/disclosed matters, forward-looking warranties, civil or criminal fines, consequential losses, purchase price adjustments, secondary tax liabilities, transfer pricing risks, environmental liabilities and anti-bribery/corruption liabilities.

The typical cost of such insurance is around 1.5% of the insured amount.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Where the warranties are limited to title, capacity and authority, the private equity seller's liability is either uncapped or capped at the amount of consideration paid. The private equity seller and management team's liabilities for other warranties are usually capped, and the amount of the cap may range from 10% to 100% of the consideration paid depending on the type of warranty and the strength of each party's bargaining position. Liability under covenants, indemnities and undertakings may not be subject to such caps.

Where known risks are identified, an escrow amount may be set aside from the consideration to satisfy such claims.

General limitations, such as time limits within which claims must be made and a *de minimis* threshold before claims can be made, are also customary.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Generally, private equity sellers do not provide security for warranty claims.

While private equity buyers will try to insist on such security being provided by sellers, the agreement reached between buyer and seller ultimately depends on their respective bargaining strengths.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

The purchase agreements or bid letters typically include a commitment or warranty from the private equity fund that it has sufficient financial resources to complete the transaction. A bank commitment letter may also be provided in certain cases to provide comfort on the availability of financing where certain funds are required. Such commitments are generally enforceable by the seller against the private equity fund, but bank commitment letters are only intended to provide soft comfort to sellers and are usually not enforceable against the bank.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are not common in Singapore.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

- Prospectus Liability. A private equity seller participating as a vendor in an IPO is responsible for the accuracy of the prospectus to be issued as part of the public offering of securities under the IPO. Singapore law imposes criminal and civil penalties for false or misleading statements or omissions in the prospectus.
- Prospectus Disclosure. An IPO prospectus is required to disclose all material information, including background information on all vendors in the IPO.
- Lock-ups. A private equity seller may be subject to lock-up requirements under the listing rules of the Singapore Exchange – please see the discussion in question 7.2 below.
- Interested Person Transactions. If the private equity seller retains a shareholding of 15% or more post-listing, it will be an "interested person" for the purposes of the listing rules of

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the Singapore Exchange and any transactions between the private equity seller (or any of its associates) and the listed company (or any of its subsidiaries or unlisted associated companies) will be "interested person transactions". Depending on the materiality of the value of the transaction, the listing rules may require announcements to be made and/or prior shareholder approval to be obtained.

- Takeovers. The conversion of the portfolio company into a public company will subject its shareholders to the takeover regime under Singapore law, which requires a general offer to be made by any person who, together with its concert parties, either: (a) acquires 30% or more of the voting rights of the company; or (b) holds at least 30% but not more than 50% of the voting rights of the company, and acquires additional shares carrying more than 1% of the voting rights within any six-month period. A private equity seller considering an IPO exit should bear these thresholds in mind when structuring its anticipated level of post-listing shareholding interest.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

If the private equity seller retains a shareholding of 15% or more at the time of listing, the listing rules of the Singapore Exchange will require a lock-up to be given by the seller over all of their shares for a period of either six or 12 months after listing, depending on the admission criteria upon which the company is listed. If the private equity seller retains a shareholding of less than 15% at the time of listing, the listing rules of the Singapore Exchange will also require a six-month lock-up to be given over a proportion of the shares acquired within a period of 12 months preceding the date; the proportion of shares subject to the lock-up reflecting the proportionate price discount enjoyed by the private equity seller in acquiring such shares, compared to the IPO price for the shares.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Because they are costly, dual-track exit processes are only undertaken when private equity sellers are unsure which option is more likely to be consummated. It follows that private equity sellers are also keen to end the dual-track as soon as it becomes apparent that consummation of the preferred option is imminent.

Recently, most dual-track deals have been realised through a sale and not an IPO.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Traditional bank financing through loans remains the most common source of debt finance for private equity transactions in Singapore. The financing market remains fairly stable and banks continue to show a willingness to support leveraged finance transactions, taking into consideration factors such as the quality of target assets, the track record of the sponsor, the debt quantum, pricing and security packages.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

Leveraged buyouts typically involve a debt pushdown following completion where the target company takes over the acquisition debt and gives a security package over its assets to the lender.

Such an arrangement constitutes financial assistance on the part of the target company and may have to be whitewashed by its shareholders if it is a public company or a subsidiary of a public company. The prohibition against giving such financial assistance no longer applies to private companies, unless their parent is a public company.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

Given the continued interest in socially responsible investments, there are more instances of green debt or sustainability financing. Such borrowings may enjoy better rates if they are utilised towards sustainability projects or if the borrower maintains or improves on its environmental, social or governance targets.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Any income accruing in or derived from Singapore (i.e. sourced in Singapore) or accruing or derived from outside Singapore (i.e. sourced outside Singapore) which is received or deemed received in Singapore, is subject to income tax in Singapore. There is no capital gains tax in Singapore.

Foreign-sourced income in the form of dividends, branch profits and service income received or deemed to be received in Singapore by a Singapore-resident company are exempt from tax if certain conditions are met, including: (i) such income is subject to tax of a similar character to income tax under the law of the jurisdiction from which such income is received; and (ii) at the time the income is received in Singapore, the highest rate of tax of a similar character to income tax levied under the law of the territory from which the income is received, on any gains or profits from any trade or business carried on by any company in that territory at that time, is not less than 15%.

All Singapore-resident companies are under the one-tier corporate tax system. Under this system, the tax on corporate profits is final and dividends paid by a Singapore-resident company are tax-exempt in the hands of a shareholder (regardless of whether the recipients of such dividends are individuals or corporate entities) and no Singapore withholding tax will be imposed on such dividends.

Where private equity acquisitions are financed (wholly or partly) through debt, any payments in the nature of interest which are borne by a person or permanent establishment in Singapore and paid to a person not resident in Singapore would be subject to withholding

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tax in Singapore. However, the withholding tax rates may be reduced by tax treaties and certain exceptions from withholding tax may also be applicable. For instance, a withholding tax exemption may be available for qualifying debt securities where certain conditions are met, and where Singapore financial institutions with the relevant incentives have arranged such issuance.

Certain tax incentive schemes may also be available for qualifying Singapore or non-Singapore tax resident funds which are managed by Singapore-based fund managers. Specified income of qualifying funds derived from a prescribed list of designated investments may be exempt from tax under the fund management incentive schemes. Various conditions must be met by both the fund and the fund manager.

Off-shore structures are quite commonly used – please see the discussion in question 2.1 above.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Unlike the UK, "rollover relief" is not available in Singapore.

As there is no capital gains tax in Singapore, one of the key considerations for private equity transactions is whether the gains from such transactions constitute capital gains or trading income, the latter of which is subject to Singapore income tax. For example, the gains from a sale of shares may be regarded as trading income and subject to income tax if the entity disposing the shares is regarded by the IRAS to be trading in such shares or having acquired such shares for subsequent disposal for a profit (as opposed to acquiring such shares for long-term investment holding purposes).

Certain "safe harbour" rules have been enacted in Singapore whereby gains derived by a divesting company from its disposal of ordinary shares in an investee company are not taxable if certain conditions are met (the "Certainty of Non-Taxation Rule"). This rule provides that gains derived by a qualifying divesting company from its disposal of ordinary shares in an investee company during the period from 1 June 2012 to 31 May 2022 are not taxable if: (a) immediately prior to the date of the disposal, the divesting company has held at least 20% of the ordinary shares in the investee company for a continuous period of at least 24 months; and (b) the shares disposed of are ordinary shares, and not preference, redeemable or convertible shares. This rule does not apply to: (i) a divesting company whose gains or profits from the disposal of shares are included as part of its income as an insurer; and (ii) an unlisted investee company that is in the business of trading or holding Singapore immovable properties (other than the business of property development).

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

There are no key tax-efficient arrangements (such as "entrepreneurs' relief" or "employee shareholder status" in the UK) available in Singapore. Share-based equity plans may be implemented, and awards pursuant to such plans are generally taxable, depending on when they vest (or are exercised, in the case of options) and whether disposal restrictions apply to the shares awarded.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

On 11 March 2017, amendments to the Stamp Duties Act were passed imposing additional conveyance duties on the acquisition and disposal of certain equity interests in property holding entities that have an interest (directly or indirectly through other entities) in Singapore residential properties, as if such acquisition or disposal were a conveyance of the underlying interest in the residential properties. The changes were introduced to ensure parity of treatment in the stamp duty to be paid when a person acquires or disposes Singapore residential property directly, versus acquiring or disposing of the equity interests of the property holding entity which has an interest in the Singapore residential property. Save as stated, no significant changes have been introduced, nor are any anticipated that would impact private equity investors, management teams or private equity transactions.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

The Singapore Companies Act was updated in 2015 to abolish the concept of financial assistance for private companies and the introduction of new exemptions to financial assistance for public companies. This facilitates leveraged buyouts by making it easier to effect debt pushdowns by purchasers post-completion. The procedures for the amalgamation of companies have also been simplified, and directors of amalgamating companies will no longer be required to attest to the amalgamated entity's solvency on a forward-looking basis.

Following the completion of two rounds of consultation, the Singapore Exchange has implemented its regulatory framework for dual class share (DCS) listings with effect from 26 June 2018, paving the way for firms with different voting rights to raise funds through an IPO in Singapore. DCS listings are subject to safeguards against the risks of expropriation (when owner managers seek to extract excessive private benefits from the company to the detriment of minority shareholders) and entrenchment (when owner managers become entrenched in management of the company).

In 2018, legislation was enacted to introduce a new corporate structure tailored for investment funds. Known as the Variable Capital Company (VCC), the new corporate structure will allow investment funds to use a single entity to house multiple sub-founds, apply US GAAP accounting standards and allow dividends to be distributed from capital with the assets, and liabilities of the sub-funds would also be segregated. Further consultations and accompanying legislation designed to operationalise the framework for the VCC structure is expected to take place in 2019.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

Private equity investors are not subject to enhanced regulatory

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scrutiny. Generally, only transactions involving regulated industries will be subject to enhanced regulatory approvals – these include, *inter alia*, acquisitions exceeding the prescribed percentage in Singapore incorporated banks, capital markets services licensees, licensed insurers and telecommunications providers. Public-to-private transactions will also need to comply with the regulatory regime under the Singapore Code on Takeovers and Mergers.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

Private equity investors typically engage outside counsel to conduct legal due diligence on the target prior to any acquisition. Timeframes for conducting legal due diligence vary and usually take between one to three months. Such legal due diligence is usually conducted on an "exceptions only" basis, and the materiality and scope will depend on the private equity investor's internal compliance and financing requirements, the complexity of the target's business and the timeframe for the particular acquisition.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Compliance with applicable anti-bribery and anti-corruption laws is a prerequisite to most, if not all, private equity transactions in Singapore. If non-compliance is a concern, private equity investors will usually seek to restructure the transaction to isolate the risk (e.g. by acquiring assets instead of shares).

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Singapore courts would generally not pierce the corporate veil and/or hold a private equity investor liable for the liabilities of underlying portfolio companies or hold one portfolio company liable for the liabilities of another portfolio company in the absence of fraud or bad faith.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Singapore is an investor-friendly jurisdiction and is consistently ranked as one of the easiest countries in which to do business. Most laws and regulations are in line with international best practices and should not cause too much concern on the part of experienced private equity investors.

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Kee Yeng has been recognised for her work in Corporate and M&A in *Chambers Global*, *Chambers Asia-Pacific* and *IFLR1000*. She has also been recommended by *The Legal 500 Asia Pacific* for public mergers and acquisitions.

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South Africa

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

The South African market continues to see a substantial number of private equity (PE) transactions by local and foreign PE houses, including leveraged buyouts, buy-ins, follow-on acquisitions, exits and Broad-Based Black Economic Empowerment (B-BBEE) transactions (see question 11.1 below). Recent years have seen an established trend in exits by way of auction/managed disposal processes and an increasing number of secondary PE transactions (demonstrating that the PE market in South Africa is maturing).

2017 and 2018 saw a slowing of deal activity and some failed deals due to parties watching and waiting on South African political changes, and it is anticipated that activity will pick up following the May 2019 general elections. In addition, there has been strong fund formation activity, including the formation of new B-BBEE funds, which we expect will drive deal activity as capital is raised and deployed.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

In an African context, South Africa is seen as a jurisdiction with strong and efficient banking and regulatory institutions, an established legal system, as well as access to debt and capital markets including the Johannesburg Stock Exchange (JSE), which is highly regarded. There is also a wide range of mature businesses allowing larger deployments of capital or investments in earlier-stage or mid-cap businesses, depending on fund mandates.

The South African Rand is relatively volatile, which can be to the advantage or disadvantage of an investment depending on the timing, although this is not necessarily an unusual attribute for investors looking to invest in emerging markets.

The creation and listing of permanent capital vehicles on the JSE has been a notable trend which has provided access to a new pool of institutional capital via listed instruments. Whilst we note that there have been fewer listings of permanent capital vehicles in the last year, as noted above, fund formation activity remains strong.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

We expect to see deal activity pick up following the May 2019 general elections, and as the South African economy returns to (modest) growth. There will also be deal flow generated by the maturing of current fund vintages and new capital being raised for new funds, and we expect to see more transactions from captive funds within banks and corporates.

The economic cycle has created opportunities for PE players to pursue delisting transactions and to acquire businesses or divisions of listed groups needing to rationalise and pay down debt, and these trends are likely to continue to play out.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

In most leveraged buyout transactions, a “debt push down structure” would be used in order to facilitate the introduction of acquisition debt on an efficient basis. This involves a two-stage transaction whereby, in the first stage, the purchaser (Bidco) acquires the shares in the target company using equity funding and a bridge loan. Shortly thereafter, the assets of the target company are acquired by a new company (Newco), typically a subsidiary of Bidco, using term debt (being debt with a longer repayment profile). The proceeds of the business acquisition are then distributed to Bidco and Bidco applies the proceeds to settle the bridge loan.

Subscription and buy-back structures have often been used as an alternative to traditional share sale transactions.

2.2 What are the main drivers for these acquisition structures?

The use of a debt push-down structure allows the funding bank to take direct asset security from Newco, as well as a pledge over Bidco’s shares in Newco. It also allows the target company to be liquidated in order to mitigate any historical liabilities and is efficient from a tax perspective (subject to certain interest-deduction limitations).

Subscription and buy-back structures have provided a tax-efficient exit for disposing shareholders (especially South African tax-

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resident corporate shareholders). However, amendments over the last few years have limited the efficiency and use of this structure in the future, and these structures will only be applicable in limited instances.

The main driver for many minority investment/buy-in transactions seems to be a desire by the founders or management of primarily South African businesses to realise value and diversify their investments, whilst retaining control and continuing to drive the growth of the business. Another driver is expansion into the African continent, where having a PE partner with capital and a well-developed continental network is seen as an advantage.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

The equity capital structure typically consists of a combination of shareholder loans, preference shares and ordinary share capital. Typically the pure equity (ordinary share) component is relatively small after taking into account third-party acquisition debt and shareholder funding in the form of shareholder loans and preference shares.

Management will generally reinvest alongside the PE investor, often on a subsidised basis. Their investment would often be held through a management trust or other investment vehicle.

Carried interest is typically dealt with as part of the fund formation and structuring, and does not typically form part of the equity structuring at individual deal level. However, "ratchet"-type structures are often used to drive exit alignment and incentivise management if a particular return hurdle is met by the PE investor at exit.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Where a PE investor is taking a minority position, it is unlikely that a debt push-down structure would be implemented as the PE investor would usually just invest into the existing group structure. Often a refinancing or restructuring would take place at the same time as the investment.

Subscription and repurchase transactions, or subscriptions coupled with the payment of pre-transaction dividends, are a common feature of structuring minority positions, but this will involve taking into account changes in tax treatment.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Management would generally hold a minority stake of between 10% and 40% of the equity investment. This is, however, heavily dependent on the size of the target, and also whether the management in question are also founders.

The extent to which management shares may vest over time will usually depend on whether such management shares were subsidised and, if so, to what extent (i.e. if management paid full value for their shares, they would acquire their shares outright and there would be no vesting). Vesting would typically occur over a period of three to five years, and affect the value received by the holder should they terminate their employment.

The shareholders' agreement would typically contain compulsory offer or option provisions which would apply on termination of employment, with pricing and other terms dependent on vesting and the reason for the departure.

Any vesting and/or compulsory offer provisions in relation to management shares should be analysed from a tax perspective.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Death, disability or retirement would generally constitute a management member a good leaver. Voluntary departure or dismissal would constitute bad leaver events, and in some cases aggravated bad leaver provisions would apply in the event of fraud or other serious misconduct.

The good leaver/bad leaver determination would generally affect the value received for the shares rather than whether an offer is triggered. A good leaver will generally receive the fair market value for his/her shares (subject to any vesting provisions) while a bad leaver will be penalised in some way.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

The governance arrangements in respect of a portfolio company are contained in its constitutional document, namely its memorandum of incorporation and the shareholders' agreement, which would usually set out, at a minimum: (i) the composition of the board (which is dependent on the shareholding structure); (ii) the conduct of board and shareholder meetings; (iii) specially protected matters (veto rights) in favour of the PE investor or other shareholders; (iv) provisions regarding the future funding requirements of the portfolio company and the further issuance of shares and/or the advancement of shareholder loans; and (v) restrictions on the transferability of shares and shareholder loans, as well as tag-along, drag-along and exit provisions.

The day-to-day management of the portfolio company is the responsibility of the board over which a majority PE investor will usually have control. Where the PE investor only acquired a minority stake and does not control the board, it would expect to have veto rights in respect of certain specially protected matters at shareholder level.

Whilst the shareholders' agreement is a private contract between the shareholders *inter se*, and between the shareholders and the portfolio company, any inconsistency between the shareholders' agreement and the memorandum of incorporation will result in the memorandum of incorporation superseding the shareholders' agreement. The memorandum of incorporation must therefore be aligned with the shareholders' agreement. The memorandum of incorporation is required to be lodged with the Companies and Intellectual Property Commission and is, in principle, a public document.

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3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

In terms of the Companies Act 71 of 2008, as amended (Companies Act), ordinary resolutions can be passed with majority support, and special resolutions with the support of at least 75% of the ordinary voting rights. These thresholds can, however, be altered in the memorandum of incorporation.

A shareholder holding a majority stake would (by default) be able to elect the board of directors, and a shareholder holding 25% or more would be able to block special resolutions.

In addition to corporate actions requiring a special resolution, the memorandum of incorporation and shareholders' agreement may set out additional specially protected matters or veto rights. The extent of these protections would vary depending on the size of the PE investor's stake, but would typically be extensive if the PE investor holds more than 25%, and certainly include vetos over material acquisitions and disposals, business plans and related party transactions. Generally, veto rights apply at a shareholder level.

Where significant veto rights are obtained by a minority shareholder, it should be assessed whether negative or joint control has arisen for competition law purposes and whether a notification to the competition authorities is required.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

Any veto arrangements contained in the portfolio company's memorandum of incorporation and/or shareholders' agreement will be void to the extent that they contravene or are inconsistent with the Companies Act. This does not generally present any practical difficulty, however.

Directors are subject to fiduciary duties in favour of the company, which may potentially conflict with the interests of a particular shareholder. Accordingly, it is best if veto rights are exercised at shareholder level (rather than through the board), but a PE investor's veto rights can be structured so as to be effective at either level.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

As noted above, directors (including the PE investor's nominees) would have fiduciary duties to the company, and by proxy the shareholders, when acting in their capacity as a director. This is discussed in more detail below.

Whilst shareholders do not generally owe any duties to each other, section 163 of the Companies Act does provide a shareholder with relief from oppressive or unfairly prejudicial conduct on the part of another shareholder. This section allows a court to come to the assistance of a shareholder if the shareholder satisfies the court that an act or omission of the company or another shareholder, or the manner in which it has conducted its affairs, is unfairly prejudicial, unjust or inequitable, or unfairly disregards the interests of the applicant.

In reaching its decision, a court would take account of the underlying motives of the majority in deciding whether particular conduct requires relief, and our courts uphold the general principle that by becoming a shareholder a person undertakes to be bound by the decisions of the prescribed majority of shareholders provided that these are in accordance with the law. Accordingly, mere dissatisfaction with the conduct of the company's affairs or the majority shareholders will not of itself constitute grounds of prejudice, injustice or inequity within the meaning of the section.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

A shareholders' agreement must be consistent with the Companies Act and the relevant portfolio company's memorandum of incorporation, and any provision of a shareholders' agreement that is inconsistent with the Companies Act or the company's memorandum of incorporation is void to the extent of the inconsistency.

It is permissible for the shareholders' agreement relating to a South African portfolio company to be governed by foreign law and for the parties to submit themselves to the jurisdiction of foreign courts, provided that this does not give rise to any conflicts between the shareholders' agreement and the Companies Act or a contravention of the Companies Act.

To the extent that the shareholders' agreement contains any non-compete and/or non-solicitation provisions, they must be reasonable as to, *inter alia*, (i) geographic area, and (ii) time period, and should be limited to what is reasonably required in order to protect the legitimate interests of the PE investor and its investment in the portfolio company. The courts tend to scrutinise restraint provisions more closely when applied to individuals, given public concerns regarding employment and the right to a trade.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

Before appointing its nominees as directors to the board of a portfolio company, a PE investor should ensure that such nominee is not ineligible or disqualified (e.g. because he/she is an unrehabilitated insolvent) to be a director as set out in section 69 of the Companies Act. Foreign directors may be appointed and there is no requirement to have a particular number of (or any) local directors.

The common law duties of directors have been partially codified in sections 75 and 76 of the Companies Act. These consist of fiduciary duties and duties of care, skill and diligence. To the extent that such duties have not been codified, the common law continues to apply.

Directors are required to exercise their powers and perform their functions in good faith, for a proper purpose and in the best interests of the company. Furthermore, a director cannot use his position on the board or information obtained by virtue of his position to gain an advantage for anyone other than the company or a wholly owned subsidiary, nor to do harm to the company or any subsidiary (whether wholly owned or not) of the company. Directors are also

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required to disclose all information they believe to be relevant to the company, unless they are subject to a legal or ethical obligation not to disclose it.

A director is required to exercise the care, skill and diligence that may reasonably be expected of a person carrying out the same functions as that director and having the general knowledge, skill and experience of that director.

In terms of section 77 of the Companies Act, a breach of these duties may attract liability for a director in his or her personal capacity.

Furthermore, although directors' duties and liabilities in the Companies Act are owed (in line with the common law) to the company and not to the shareholder appointing the director, where applicable, section 218(2) of the Companies Act effectively extends the remedies available for a breach of any duty contained in the Companies Act to anyone who has suffered loss due to the breach.

Typically, PE investors would require that a portfolio company take out D&O insurance to provide protection to its nominee directors.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

As set out above, directors owe their fiduciary duties to the company and not to the PE investor appointing him/her.

In terms of section 75 of the Companies Act, a director is required to avoid any conflicts of interest and accordingly, if he has a material personal financial interest in a matter before the board, he is required to recuse himself from all discussion on that matter. However, a decision by the board will be valid despite any personal financial interest of a director or a person related to the director if it has been ratified by an ordinary resolution of the shareholders.

Due to the risk of nominee directors or the PE investors appointing them being regarded as having a personal financial interest in any decisions of the board, it has become practice for board resolutions in respect of major corporate, commercial and/or financial decisions to be ratified by shareholder resolutions.

In an effort to limit any potential conflicts of interest, it is recommended that veto rights and the like fall to the shareholders and not be exercised at board level.

A conflict would typically only arise between portfolio companies where they are in competition or transact with one another. The director would need to make the appropriate disclosure to the respective boards and recuse himself where necessary. Where portfolio companies are in competition or similar sectors, competition law may prevent common directorships.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

PE transactions in South Africa typically take about 12 weeks from signature of the transaction agreements until completion. This is largely due to regulatory approvals, including competition approvals (in South Africa and, if applicable, other Sub-Saharan African jurisdictions) and exchange control approval from the Financial Surveillance Department of the South African Reserve Bank. Additional regulatory approvals may also be required in respect of certain specific industries/sectors (e.g. the mining, banking, insurance, security, media and broadcasting industries).

4.2 Have there been any discernible trends in transaction terms over recent years?

Over recent years, use of the "locked-box" purchase price mechanism and warranty and indemnity insurance have become common features of PE transactions in South Africa.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

The main features of a public-to-private transaction relate to the application of the takeover provisions contained in sections 117 to 120 of the Companies Act (Takeover Provisions), the Takeover Regulations and the JSE Listings Requirements, which impose stricter rules and disclosure requirements (as opposed to those applicable to private acquisitions) and a greater amount of publicity.

The Takeover Provisions and Takeover Regulations are aimed at ensuring transparency and fairness to shareholders in regulated companies in the conduct of specific transactions known as "affected transactions". These transactions, which will require notification to and a clearance certificate from the Takeover Regulation Panel, include: (a) a disposal of all or the greater part of the undertaking of a regulated company; (b) an amalgamation or merger involving at least one regulated company; (c) a scheme of arrangement between a regulated company and its shareholders; (d) the announced intention to acquire a beneficial interest in the remaining voting securities of a regulated company not already held by a person or persons acting in concert; (e) mandatory offers (triggered by an acquisition of more than 35% of the voting securities of a regulated company); and (f) "squeeze-out" transactions (which may be exercised by a shareholder who acquires more than 90% of the voting securities of a regulated company).

For purposes of the Takeover Provisions and the Takeover Regulations, all public companies and certain state-owned companies are "regulated companies". A private company will also be a "regulated company" if more than 10% of the issued shares of that company have been transferred, other than by transfer between or among related or inter-related persons, within the period of 24 months immediately before the day of a particular transaction or offer. In addition, a private company may, in its memorandum of incorporation, elect to be a "regulated company".

Public-to-private transactions in South Africa are invariably implemented by way of a scheme of arrangement proposed by the board of the target to its shareholders, as the scheme of arrangement, if approved, allows the PE investor to acquire 100% of the target (and thus delist it).

The main challenges faced by PE investors would include: (i) obtaining board approval for the transaction (as the board would need to propose the scheme of arrangement); (ii) getting certainty regarding the deal, as the approval of 75% of the shareholders would be required, and there are restrictions on approaching shareholders prior to a firm intention announcement; (iii) financing must be secure at an early stage as bank guarantee or cash confirmation is required at firm intention stage; and (iv) restrictions on the

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conditionality of the deal, as the scheme of arrangement may be subject only to objective conditions. In addition, due to the central role played by the board in recommending (or not recommending) the transaction to shareholders, hostile transactions can generally be blocked by the company.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

The primary protection that can be obtained are break fees agreed with the target, which are permissible and are commonly agreed. However, the Takeover Regulation Panel requires that break fees be limited to 1% of the offer value and the details thereof must be fully disclosed. In addition, a PE investor may negotiate certain restrictive provisions with the target, with a view to limiting the possibility of a competing offer being accepted by the target. Generally, however, it is not possible to prevent a target accepting or approving a superior offer if one is made.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

PE sellers prefer the "locked-box" pricing structure, whilst on the buy-side completion accounts are generally preferable. It is more common for sellers and buyers to settle on a "locked-box" structure; however, these often have hybrid elements, for example by including verification/adjustments for deviations in, for instance, net working capital, net asset value and/or net debt.

It is also not uncommon to see earn-out structures or "*agterskot*" (deferred) payments where a portion of the purchase price is paid on completion with a further amount only payable on a later date and upon the target meeting certain performance thresholds.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

In South Africa, both the PE seller and the management team are typically expected to provide a full suite of business warranties, *pro rata* to their shareholding percentages in the target company. However, as mentioned below, warranty and indemnity insurance is commonly taken out to cover the negotiated warranty and indemnity package and provide a clean exit to the PE seller.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Interim period undertakings in relation to: (i) the conduct of the business between the signature date and the completion date; (ii) no leakage (in a "locked-box" transaction structure); and (iii) cooperation and assistance with regulatory filings, are standard.

Indemnities are not typical, but may be agreed where specific risks have been identified as part of the due diligence (in which case the indemnity may be insured).

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

Whilst in the South African market it is expected that PE sellers will provide business warranties, it has become the norm (particularly in larger transactions) to obtain a warranty and indemnity insurance policy. In auction/managed disposal processes, this is usually a requirement of the process, and the preliminary terms for a buyer warranty and indemnity insurance policy would often be provided in the data room as part of the proposed transaction documentation.

A warranty and indemnity insurance policy will typically have a *de minimis* threshold equal to 0.1%, and a floor equal to 1%, of the target's enterprise value. The cap for warranty and/or indemnity claims will be negotiated in line with the transaction agreements (and will typically range between 10% and 30% of the target's enterprise value). The cost of insurance for general warranty policies would usually be in the range of 1% to 2% of the coverage limit.

Environmental, anti-corruption, transfer pricing and product recall warranties are uninsurable and excluded from warranty and indemnity insurance policies.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Warranty claims against the PE seller and management team are usually qualified by information disclosed to the purchaser prior to signature as part of the due diligence and/or in a disclosure schedule attached to the acquisition agreement.

Liability is further limited by providing the warranties on a *pro rata* basis which means that, whilst the PE investor will be liable for the largest proportion of any warranty claim, the management team is also exposed and encouraged to make full disclosure as part of the due diligence and in the disclosure schedule.

Warranty claims would be subject to *de minimis*, floor, cap and time period limitations. Where warranty and indemnity insurance is taken out, these will be aligned to the policy.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

PE sellers will typically insist on warranty and indemnity insurance so as not to be subject to an escrow withholding or deferred payment.

PE buyers will look for security to the extent that the seller (for example, an individual, trust or SPV entity) is not considered creditworthy. They may also look for security over shares held by management to the extent that warranties are obtained from management.

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6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Buyers typically rely on bank term sheets, as well as their track record in securing debt for other transactions, to provide comfort that debt financing will be available. It is, however, common for the deal to be conditional on the debt being raised, although in some circumstances a buyer may be willing to underwrite the full acquisition price.

Comfort regarding the equity component may be provided through an equity commitment letter or similar form of confirmation/undertaking, particularly where an SPV is used; however, these have tended to be soft and of limited enforceability, and parties tend to rely more on the reputation and track record of their counterparties. There was an expectation that market practices would evolve following the Abraaj collapse, but we have not seen this to be the case.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are not typical in PE transactions in South Africa. However, cost-sharing arrangements are often agreed, covering costs in respect of, for example, competition filings, in the event of a failed transaction.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

An IPO exit may provide an attractive valuation, particularly as unlisted multiples would typically be lower than listed multiples. However, the valuation would only be known once the IPO takes place and cannot be locked in in advance. In addition, due to the lock-ups mentioned below, it is usually not possible to achieve a full exit immediately via IPO and there may be a hangover in the share price due to the additional shares that will be coming to market once the lock-ups expire.

In considering an exit by IPO, PE sellers should ensure that they have alignment with management and other stakeholders and are well aware of the process required to prepare the portfolio company for IPO (particularly a smaller/younger portfolio company which has not previously been listed). The possibility of an IPO and the process to achieve an IPO should be addressed in the shareholders' agreement.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

The PE seller and the management team will ordinarily be subject to a lock-up period of between six and 12 months.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Dual-track exit processes have been seen in the South African market for suitable assets; however, there is no established market practice or pattern in this regard.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Debt finance for PE transactions is most commonly sourced in the form of secured term loans from the major South African banks. The finance market is generally receptive to funding these transactions, particularly those undertaken by established sponsors, at healthy levels based on the profitability of the underlying businesses.

Mezzanine financing is not often used in larger transactions, but may be seen in smaller deals involving growth businesses.

Bonds, notes and the like are not commonly used to finance PE transactions, although there is an appetite for bonds issued to portfolio companies to refinance existing bank funding. Whilst secured bonds in the South African market have some elements of the high-yield space offshore (e.g. more covenant-light than investment-grade bonds, and incurrence rather than maintenance covenants), local bond investors have been more conservative and have been able to negotiate terms more akin to bank funding than high-yield bond funding.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

As mentioned at question 2.1 above, debt push-down structures are used to facilitate the security package and a tax-efficient structure for acquisition debt. The interest incurred on senior debt raised as part of a debt push-down would be subject to local South African interest limitation rules, which effectively looks to limit the interest expense deducted to a percentage of the target company's "adjusted taxable income".

These interest limitation rules potentially also extend to debt incurred from persons in a controlling relationship, where such controlling shareholder is not tax resident in South Africa and exempt from tax in South Africa.

When structuring the security package as part of a senior debt financing, tax events that may be triggered upon exercise of the security (especially as a result of the original acquisition structure) should also be taken into account.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

In addition to direct acquisition debt, it has been common for

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lenders to provide financing to bridge or refinance fund investments. Following the Abraaj collapse, there has been a tightening up of sanctions language and restrictions, as well as requirements for additional security (step in rights and cessions over capital calls), for these types of facilities.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

In the South African market, a key tax consideration for investors would be tax transparency, i.e. to invest through a vehicle that allows for any income (including capital gains, dividend distributions and interest payments) derived to be taxed in the investors' hands (in their tax jurisdictions) in accordance with the underlying nature of such income.

Offshore structures are common for foreign investors that seek exchange-control-friendly jurisdictions. Due to the increasing trend of foreign investors investing into South African-managed funds, it is common practice to provide for a "dual-fund" structure. The dual-fund structure provides a second mirrored partnership that is established outside of South Africa, with the same investment strategy and structure of its South African counterpart – this is the vehicle through which foreign investors will invest.

Please see question 9.4 below for a brief discussion on the South African "Headquarter Company" regime, which may provide an easier platform for foreign investors investing into South Africa, but which requires certain amendments to be made.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Given the extent of the tax legislation in South Africa governing employees' remuneration and the taxation thereof, it is important to distinguish income for services rendered (which is taxed at the individual's marginal income tax rate (currently a maximum of 45%)) from participation in the growth of the underlying PE portfolio companies (which is taxed in an individual's hands at an effective capital gains tax rate of 18% on the ultimate disposal of the underlying portfolio companies).

The wide scope of the tax legislation has, in certain instances, inadvertently resulted in participation schemes (i.e. participation in the growth of the underlying PE portfolio companies) subjecting employees to tax at their marginal income tax rates. This should not be the position where management invests as an ordinary shareholder or investor, and is subject to the same risks and rewards as other investors. However, please see the discussion regarding section 8C in question 9.4 below.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

A key tax consideration for management teams would be to roll-over their existing investment into a new acquisition structure in a tax-neutral manner. This is especially so where such management teams are not realising their investment, and will have no realised proceeds to settle any tax that may be triggered.

There are various tax roll-over concessions contained in the South African Income Tax Act, which may assist in achieving this desired outcome for management. However, these are becoming increasingly limited and need to be considered in detail.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

The tax rules (primarily section 8C) that regulate the taxation of employees in respect of share incentive schemes are constantly modernised to cater for the perceived abuse of such incentive schemes. Section 8C seeks to include in (or subtract from) an employee's income the gain (or loss) arising upon the vesting of an equity instrument, where such equity instrument was acquired by that taxpayer by virtue of his/her employment or from any person by arrangement with that person's employer.

With effect from 1 March 2017, an amendment to the section 8C rules provided that gains and non-exempt dividends vested by employee share trusts are taxed as income in the hands of the beneficiaries. This amendment, together with amendments passed in 2016, created the potential for double taxation in employee share trusts where the trust vests shares or share gains in employees, who will also pay income tax on the share or gain as remuneration. This legislation was retrospectively amended to provide for an exemption where employee share trusts vest the share gain (made on the disposal of the underlying shares) in the hands of the beneficiaries. As a result, the employee share trust will not also be taxed on any gains.

However, this amended position does not necessarily apply where the employee share trusts vest the underlying shares in the hands of the beneficiaries. In this case, the legislation is ambiguous and could still result in double taxation. There are binding private rulings issued by the South African Revenue Service that provide that no double taxation should occur in this scenario. However, because these rulings are non-binding and there are no reasons provided for the ruling, limited reliance can be replaced on such rulings.

As noted in question 9.1 above, the dual-fund structure has become common practice in South Africa for investments that need to be made outside South Africa (i.e. into Africa). Although the dual-fund structure is highly effective, the formation process is quite burdensome and is becoming increasingly difficult to manage for South African funds. In order to compete with exchange-control - friendly jurisdictions, South Africa has introduced the "Headquarter Company" regime that essentially mirrors the benefits of exchange-control-friendly jurisdictions. Due to the fiscally transparent nature of the South African fund, the fund will not qualify for the "Headquarter Company" regime and the attendant benefits. As a result, the dual-fund structure is the only viable alternative. An amendment to the "Headquarter Company" regime that allows for South African funds to qualify would negate the necessity for the dual-fund structure.

The lobbying process to make legislative amendments to the "Headquarter Company" regime has commenced, as the South African PE landscape needs to make investing and divesting easier for foreign investors. The amendments required are not substantive and merely require an extension to the permissible shareholders, such that a fund would meet the requirements for the "Headquarter Company" regime to be applicable.

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10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

In 2018, the new Financial Sector Regulation Act (FSRA) was promulgated. The FSRA introduced what has been termed the "twin peaks" regulatory framework, in terms of which the Prudential Authority is now responsible for regulating banks, insurers, cooperative financial institutions, financial conglomerates and certain market infrastructures, and the Financial Sector Conduct Authority (FSCA) is the market conduct regulator of financial institutions, that provide financial products and financial services. This means that the name of the regulator for PE fund managers has changed from the Financial Services Board (FSB) to the FSCA.

The prudential investment limits for local pension funds were amended in 2011 to expressly permit pension funds to invest up to 10% of their assets in PE funds (with sub-limits of 2.5% per PE fund and 5% per fund of funds). The relevant regulations stipulate various requirements that a PE fund needs to comply with in order to qualify for investment purposes – these apply equally to local and foreign PE funds. The most significant requirements contained in the conditions are the following:

- fund managers must be members of SAVCA, the local industry body, and licensed under FAIS (foreign investment managers fall within a less onerous licence category);
- the auditors of the PE fund must verify the assets of the PE fund on a biannual basis and the PE fund must produce audited financial statements complying with international financial reporting standards within 120 days of the end of its financial year;
- the PE fund must have clear policies and procedures for determining the fair value of its assets in compliance with the International Private Equity Valuation Guidelines, and any valuations must be verified at least annually by a third party; and
- the pension fund must consider a list of prescribed due diligence matters before investing in a PE fund, including the fee structure of the PE fund and the risk and compliance policies and procedures of the PE fund.

The FSCA was considering the creation of a new category of FAIS licence for PE fund managers. However, we understand that the current thinking is to regulate this not under the FAIS Act, but under the proposed Conduct of Financial Institutions Bill, which has not yet been promulgated.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

PE investors are not subject to particular regulatory scrutiny. PE transactions are scrutinised by the competition authorities similar to other M&A transactions. Other regulatory approvals or scrutiny would only apply in specific regulated industries (extractive industries, banking, insurance and telecommunications amongst others).

In some recent matters we have seen increased scrutiny by the competition authorities regarding the extent of PE firms' interests in companies and competitors in the same market. This is in line with new express factors that have been introduced by the Competition Amendment Act (which is not yet in force), which the authorities will need to consider in assessing mergers in the future – e.g. the extent of common ownership by parties in an industry or in related markets, and the extent of other transactions and "creeping mergers" by the parties.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

PE investors usually conduct comprehensive legal due diligence on the target prior to an acquisition. The scope and materiality threshold will typically depend on the nature and size of the target's business, and will be determined by the PE investor in consultation with its investment committee and advisers. PE investors will usually engage outside legal counsel to conduct the legal due diligence (including, *inter alia*, corporate, commercial, employment and intellectual property arrangements) which would typically be completed in between three and six weeks (depending on the size and complexity of the target). Compliance due diligence (including anti-corruption/bribery compliance and know-your-client (KYC) checks) may be done in-house with support from outside counsel.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Yes, particularly in respect of international PE investors subject to foreign laws (including the US Foreign Corrupt Practices Act and the UK Bribery Act). Locally, the Financial Intelligence Centre Act (FICA) imposes KYC requirements on "reporting institutions" to identify clients and report transactions to the Financial Intelligence Centre. Amendments to FICA to bring it in line with international standards, including introducing requirements in relation to "politically exposed persons", have recently been signed into law. The Prevention and Combatting of Corrupt Activities Act also allows for international reach in that it criminalises corrupt actions undertaken outside South Africa by any South African citizen, anyone domiciled in South Africa, or any foreigner, if: (i) the act concerned is an offence under that country's law; (ii) the foreigner is present in South Africa; or (iii) the foreigner is not extradited. It also criminalises the act of not reporting attempted or actual corrupt transactions.

Conducting a compliance due diligence (including anti-corruption/bribery compliance and KYC checks) is expected and PE investors are increasingly looking for contractual protection against possible non-compliance by way of anti-corruption/bribery warranties (which are typically excluded from any warranty and indemnity insurance policy).

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

The general principle is that shareholders (including PE investors investing in South African companies) have limited liability and will not be held liable for the liabilities or obligations of underlying portfolio companies. Accordingly, a PE investor could not be held

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liable unless the PE investor provides direct warranties, indemnities and/or guarantees in respect of the actions or obligations of the portfolio company.

There are instances where a court may be willing to "pierce the corporate veil" in very specific circumstances. In addition, particular pieces of legislation, for example, environmental legislation and tax legislation, would impose liability on shareholders in certain instances.

It is unlikely that one portfolio company would be liable for the liabilities of another portfolio company unless they, for example, provide cross-guarantees for each other's debts.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

B-BBEE is a policy of the South African government intended to empower and promote the participation in the economy of historically disadvantaged South Africans. The policy is given effect to primarily by the Broad-Based Black Economic Empowerment Act (B-BBEE Act) and the Codes of Good Practice on B-BBEE which create a system by which entities are measured for B-BBEE purposes in accordance with stipulated scorecards. Importantly, no sanction or prohibition on trading arises from a low measurement or failure to comply; however, as B-BBEE will be a key factor in government and public entities' decisions to do business with an entity, and also a factor for other South African businesses doing business with an entity (procurement being one of the measurements on their respective B-BBEE scorecards), B-BBEE is a business imperative for most companies doing business in South Africa.

Accordingly, it is often necessary for PE investors to introduce B-BBEE ownership into portfolio companies to ensure an appropriate B-BBEE ownership rating. Amendments to the B-BBEE Act have introduced a requirement to report the details of major B-BBEE ownership transactions to a newly created B-BBEE Commission, as well as strengthened existing rules regarding "fronting" and other practices. Accordingly, compliance with B-BBEE requirements is something PE investors need to be aware of, and comply with, in structuring transactions.

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We are the dominant private equity practice in Africa – we understand the complexity of the environment and we provide a holistic and project-managed offering to ensure the deal is executed within the required timeline. We work with global, regional and national investors, offering a comprehensive range of legal and tax advisory services throughout Africa. Our clients include leading private equity houses, fund managers, investment firms, banks and financial institutions. What sets us apart from other legal firms in this space is the depth of our experience, expertise and talent in each of the key areas – transactional (M&A), fund formation, finance and tax.

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Spain

Ferran Escayola

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

According to the Spanish Venture Capital & Private Equity Association ("*Asociación Española de Capital, Crecimiento e Inversión"* – "**ASCRI**"), 2018 has beaten, for second year in a row, a record in the Spanish PE sector activity in terms of volume (EUR 5.844 billion, representing an increase of 18% compared to 2017).

International funds continue to be major market players accounting for 77% of the total investment volume (EUR 4.493 billion) in 118 transactions.

Several transactions above the EUR 100 million in equity have been closed in 2018 representing 63% of the total investment volume (EUR 3.697 billion). For the first time, the EUR 1 billion mark has been reached or exceeded in the Spanish market, in particular in three transactions executed by international funds.

Middle-market transactions (transactions between EUR 10 million and EUR 100 million) marked a historic record, reaching EUR 1.467 billion (an increase of 5% with respect to 2017), and distributed in 56 investments, 44 of them executed by Spanish entities.

With regards to project development, the investment in buyouts reached a total volume of 3.529 billion in 50 transactions and in growth capital 96 deals were executed, resulting in EUR 606 million. Venture capital transactions reached EUR 417 million spread in 510 transactions.

In 2018, domestic PE players (including venture capital) invested EUR 1.307 billion, an increase of 3.3% with respect to 2017, distributed in 454 transactions targeting other Spanish companies, resulting in a new record high.

On the divestment side, transactions decreased by 41% compared to 2017, totalling EUR 2.049 billion and totalling 295 transactions: 47% of said divestments were disposed to other PE and venture capital entities; 24% went to industrial investors; and 22% were share buybacks by former shareholders.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

In the last few years, Spain has experienced consistent economic growth due to several structural reforms and competitiveness.

The main drivers encouraging PE transactions in Spain have been: (i) existence of liquidity in the markets and dry powder in the PE funds; (ii) low interest rates; (iii) the existence of global deals with cross-border impact; (iv) easy access to financing (banking debt and direct lending); (v) global instability and the search for stable markets; and (vi) consolidated domestic corporates with significant international reach.

Foreign investors are still the main source of PE investment, although the recovery and consolidation of the domestic middle market reflects also an intense activity and resources availability by domestic investors.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

Assuming that markets are cyclical, and economic instability makes trends unpredictable, for 2019 we expect to maintain sustainable economic growth and a relevant PE activity in the country.

Spain has officially overcome the economic crisis and looks forward to a more stable period. The times of opportunistic investors in the Spanish market may be coming to an end and be substituted by consolidated value-creating investors. The increase in Real Estate PE transactions in Spain is expected to continue.

Although the Spanish PE market is more stable and mature, it needs a continued legislative development to remain competitive *vis-à-vis* other investment destinations in the European Union ("**EU**") and worldwide. In this regard, in 2018 ASCRI issued a good governance practices code for PE companies raising funds or investing in Spain aimed to align the interests of managers and investors and promote corporate governance and transparency.

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2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Usually PE transactions are executed according to the following structures: (i) acquisition of companies in which a part of the purchase price is financed, that is, leveraged buyouts (“**LBO**”); (ii) financing of the growth of companies which are certainly consolidated or already have benefits; (iii) replacement of part of the current shareholding structure (typically for family businesses and in succession situations); and (iv) investment for the restructuring or turnaround of the company.

Transactions may be executed by regulated funds named “*entidades de capital riesgo*”, through direct investment in the target companies or through a holding vehicle (“**BidCo**”) whose shareholders are the PE funds, jointly with its shareholders and the fund management team, when applicable. BidCo is the acquiring entity and is also often the borrower if any acquisition financing is needed.

Transaction structures for foreign PE investments are, in general, driven by tax efficiency (mainly the tax treatment of dividends and capital gains at the exit). International PE companies usually canalise the investment through Spanish ETVE (“*entidad tenedora de valores extranjeros*”) structures to invest in most Latin American targets to take advantage of the bilateral Double Tax Treaties signed by Spain and Latin American countries. Alternatively, subject to the tax residency of the investors, another frequently used structure consists of the incorporation of a vehicle in a tax-efficient EU country on top of the ETVE structure (provided that valid economic reasons and sufficient substance, following OECD’s BEPS regulations are met).

2.2 What are the main drivers for these acquisition structures?

The main drivers for PE transactions mainly relate to: (i) financial considerations and the ability to grant enough warranties to the financial entities; and (ii) tax reasons, not only tax-efficiency but also requirements imposed by the country of origin or by Spanish tax regulations for tax deductibility.

Other drivers such as: (i) the expected returns for the investor; (ii) the role and incentives of the management team and PE sponsors; (iii) the economic and operational costs related to the post-closing restructuring of the company; and (iv) the foreseen rules and costs of exit may dictate the acquisition structure.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

As mentioned above, PE transactions can be executed directly in the target company or channelled through a BidCo.

The investment of the management team is sometimes (partially) financed through loans that could be provided by the PE sponsors, to be re-paid as management bonus compensation, or even at exit. This financing could also be provided by the target company, if not restricted by financial assistance provisions under Spanish or other applicable laws, and re-paid also with management’s bonus or at exit.

It is also customary that management invests only in equity whilst the PE sponsor provides both equity (common shares) and subordinated financing (through profit participating loans or preferred shares).

Management is, in most cases, provided with sweet equity or a ratchet that vests upon exit provided that a minimum internal rate of return (“**IRR**”) is obtained and/or certain investment multiples are achieved. Usual thresholds would be an IRR of 20% and return multiples in the range of 2× to 3.5× (with intermediate levels vesting a portion of the marginal gain obtained at exit). The managers’ rights under the ratchet arrangements are usually vested throughout agreed vesting periods (four to five years are usual), and subject to good-leaver and bad-leaver events.

Carried interests paid to managers typically include a hurdle rate or cumulative compounded rate of return (usually 8% p.a.) once 100% of capital invested is distributed to all investors *pro rata* to their respective investments.

Thereafter, a full catch-up is usually distributed to management until they recover the amounts not received up to that moment, and then the amounts are distributed equally to both, investors and management, *pro rata* until the amounts distributed to investors equals around 20%–25% and/or a certain multiple of aggregate capital invested by them. From that moment onwards, there has been a split of all distributions, in which amounts received by management are substantially higher than would correspond to them according to their investment.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Majority or minority positions do not usually affect the investment.

However, in Spain, PE funds usually acquire majority stakes unless when their investment policies require otherwise or they agree to hold non-controlling positions alone or in combination with other partners; either other strategic investors, PE sponsors, or founding families. In such cases, being granted additional rights (other than those that would correspond to its proportion of share capital owned) becomes a key negotiation for PE investors with non-controlling positions, such as veto rights and reinforced majorities in strategic decisions, seats at the board of directors, exit provisions (including tag-along rights, put options, etc.) and key management retention schemes, among others.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

The management team usually takes 5%–10% of the share capital of BidCo or 15%–20% in secondary PE deals.

In addition to question 2.3 above, vesting provisions for the ratchets and other types of incentives may be structured, depending on the relevant PE sponsor, based upon (i) the time elapsed from the investment or commencement of the relationship of the manager with the company to the time of the departure of the relevant manager, and (ii) the time from the termination of the manager’s relationship with the target and the exit.

In this regard, good-leaver and bad-leaver (see question 2.6 below) provisions play an important role in management incentives, as they encourage the management team to remain in the company and to properly carry out its duties. These provisions allow the sponsor

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(and usually also the other shareholders) to purchase the equity that a manager leaving the company held at a pre-agreed purchase price. Conditions of this (mandatory) transfer of shares will vary depending on whether it is a good leaver (where sometimes it is allowed that the leaving manager keeps the shares) or bad leaver.

Call options are usually granted to ensure effectiveness of this obligation to transfer, which on some occasions are reinforced with irrevocable powers of attorney granted by the managers in favour of the PE sponsor (or the representative of the other shareholders, as applicable). Put options in favour of the managers are sometimes contemplated, but PE sponsors generally try to avoid them.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

"Good leaver" usually refers to the cease of a management equity holder for a reason they cannot control such as: (i) death; (ii) retirement; (iii) permanent illness or physical disability which renders them incapable of continued employment in their current position; and (iv) voluntary non-justified termination by the company.

On the contrary, the main reasons why management equity holders are treated as "bad leavers" may be: (i) disciplinary dismissal based on misbehaviour in the workplace; (ii) being found guilty by a court of a criminal offence jeopardising the company; (iii) voluntary resignation of the management equity holder (except if as "good leaver"); and (iv) termination by the company with fair cause based on a material breach of which they are liable.

Good leavers usually keep their shares of the company. Bad leavers, instead, are usually forced to transfer their shares, which are distributed proportionally amongst the remaining equity holders.

It may also be the case where both good and bad leavers may be obliged to transfer their shares. Thereupon, it is common to include a clause in the bylaws that states the sale price of the good leaver's shares shall be greater than both the acquisition cost and the market value of such shares. Conversely, in a bad-leaver situation, the sale price of the manager's shares is lower than both the market value and acquisition cost.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

PE investors usually have the right to appoint members in the board of directors of their portfolio companies, even when their representation in the board is higher than in the share capital. In minority investments, PE investors usually have such right, usually appointing one director, in order to control the decision-making process and to be involved with the company business. However, in cases where the PE investor holds a minority stake or for any other reason is not allowed to appoint a director, PE investors usually reserve the right to appoint an observer, who can participate in the board meetings without voting rights.

As explained in question 3.2 below, PE investors can usually impose super-majority voting requirements for the passing of certain key decisions of the company, to ensure that their favourable vote is required to adopt the relevant decision, both in general shareholders' meetings and board of directors meetings, as applicable.

Further, PE investors usually impose requirements to the company and managers to provide information to shareholders that might not otherwise be entitled by law.

Shareholders' agreements, which are usually private and confidential documents, include these provisions, as well as any other governance matters, such as the structure of the management group and the limitation to the powers of attorney to be granted to some directors and managers, etc.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

In practice, executives appointed by the management team are in charge of the day-to-day business of the company by means of the powers of attorney granted in their favour. However, such powers of attorney are generally limited so certain decisions have to be approved by the board of directors (i.e. acquisitions and disposals, business plan, related party transactions, etc.) or, according to law or as agreed by the shareholders in the general shareholders' meeting.

In this regard, PE investors with a majority stake may have influence over the decisions (as they are entitled to appoint the majority or a wide number of members of the board of directors), except over those decisions subject to veto rights for minority shareholders. When a minority stake is held and the PE investor does not have enough director nominees representing its interests, then veto rights and reinforced majorities are usually negotiated and granted in their favour.

Veto rights and reinforced majorities not only apply to decisions to be adopted in board of directors' meetings but also in general shareholders' meetings. These provisions are usually included in the bylaws of the company and/or in the corresponding shareholders' agreements.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

There are no contractual limitations on the effectiveness of veto arrangements and they can be registered in the bylaws and in the Commercial Registry.

However, the Spanish Capital Companies Act ("**LSC**") set forth some binding minimum and maximum majorities to decide on certain matters (such as the removal of directors, amendment of the bylaws or corporate restructurings amongst others) or on some matters restricting the rights of certain shareholders with the express consent of the affected shareholder. These limitations can be modified or agreed differently between the parties in the shareholders' agreement but cannot be included in the bylaws of the company or registered and therefore they become private agreements among the shareholders but are not enforceable against third parties.

Finally, the agreement to require the unanimous favourable vote for the adoption of certain matters can be made and included in the shareholders' agreement but not in the bylaws of the company as these provisions are rendered void and, therefore, are not enforceable.

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3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

PE investors have no specific duties towards minority shareholders, unless voluntarily assumed by the PE investor. Nonetheless, pursuant to the LSC resolutions of the company, they may be challenged when they are contrary to the Law, contrary to the bylaws or the company's meeting regulation or damage the interest of the company to the benefit of one or more members or third parties.

Damage to the interest of the company also occurs when the resolution, although not causing damage to the company's assets, is imposed in an abusive manner by the majority. The resolution will be understood to be imposed in abuse when, without being in response to a reasonable need of the company, it is adopted by the majority in its own interest to the unjustified detriment of the other members.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Shareholder agreements are private and only enforceable against the parties who have signed them, while bylaws and other corporate documents are public and thus enforceable against not only the company and its shareholders but also third parties.

There are no limitations or restrictions on the contents of shareholders' agreements other than the observance of law. In Spanish PE deals, the parties usually agree to subject the shareholders' agreement to Spanish law and to submit any disputes to arbitration, to ensure confidentiality and a fast process as opposed to slower public Spanish courts.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

A PE investor should be aware of the fiduciary duties it may have as director or as member of the board of directors, or those of its appointed directors. Directors may not be subject to any ground of prohibition or incompatibility to discharge their office and, in particular, to any of those established in the Law 3/2015, of March 30, 2015, and other related legislation or any statutory prohibition and, in particular, those established in the LSC.

Directors' duties are, among others: (i) duty of diligence; (ii) duty of loyalty; (iii) obligations to avoid conflicts of interest situations; and, (iv) duty of secrecy. Directors are held personally accountable for any damage caused by their acts performed without diligence or against the law or the company's bylaws.

Directors are liable to the company, its shareholders and the creditors of the company for any damage they may cause through acts (or omissions) contrary to the law or the bylaws, or carried out in violation of the duties inherent to their office, provided that there has been intentional misconduct or negligence.

Additionally, it is also important to bear in mind that these duties of directors and the related liability resulting from a breach of these duties is also extended to those persons or entities acting as "shadow" directors or "*de facto*" directors. This is the main risk applicable to PE investors that nominate directors to boards of portfolio companies.

Most directors of PE-invested companies in Spain usually contract a D&O insurance to cover their civil liability to a certain extent.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

Directors must refrain from discussing and voting on resolutions or passing decisions in which the director or a related person may have a direct or indirect conflict of interest. Excluded from the foregoing prohibition are the resolutions or decisions that affect the director in its condition as such, such as the director's appointment or removal from positions on the administration body or others similar.

In any event, directors have the duty to adopt the necessary measures to avoid situations in which their personal interests, or those on behalf of others, can conflict with the company's interests and their duties to it. Therefore, directors must also refrain from, among others, engaging in activities on their own behalf or on behalf of others that involve effective competition, whether actual or potential, with the company or that in any other way places it in permanent conflict with the interests of the company.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

PE transactions do not usually require prior authorisation, except for those undertaken in regulated sectors such as, but not limited to, gaming, financing, telecom, public concessions, energy, air transport, sports, media sectors and tour operators. Authorisations can be at an EU, national or local level depending on the applicable regulation.

Authorisations are also required for those acquisitions that result in a business concentration that exceeds certain antitrust thresholds (supervised by both Spanish and EU competition authorities).

4.2 Have there been any discernible trends in transaction terms over recent years?

In the last two to three years, auctions and IPO are gaining special prominence with respect to bilateral transactions. Recent trends include the increasing use of locked-box and earn-out structures *in lieu* of post-closing adjustments of the purchase price, as well as the use of representation and warranties insurance.

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5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Spanish takeover regulations establish that PE investors shall detail the full control chain of the funds into the takeover prospectus and all documentation must be submitted in Spanish as it will be addressed to all potential or actual shareholders.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

PE investors are usually requested to accept break-up fees when entering into auctions or competitive bids. However, these fees do not usually exceed 1% of the total transaction cost. The board of directors of the target company must have approved such fee, a favourable report by the target's financial advisors must be submitted and the terms and conditions of the break-up fee must be described in the takeover prospectus.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

Irrespective of the transaction side, PE investors usually prefer locked-box structures due to the certainty they provide (as there are no adjustments) and the simplicity and cost-efficiency in setting the price (using the latest approved financial statements). In this regard, for a proper protection of buyer under this structure, the seller will have to warrant the non-existence of undisclosed leakages in the financial statements until closing date.

Earn-out structures are still used, enabling the buyer to maximise the price if the seller keeps control over the company's management and allow the buyer to reduce overpayment risks. Earn-outs are nevertheless conflictive and may easily lead to litigation.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

PE sellers commonly have to offer a set of representations about the target company, although limited in scope and time. Escrow deposits are still between the most common warranty granted by PE sellers, in which a percentage of the purchase price is deposited in a bank account for a period of time and partial releases can be agreed.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Covenants, undertakings and indemnities are avoided as much as possible by PE sellers, to the extent that the PE sellers attempt to make the management team bear the burden. The most typically requested and controversial covenant is non-compete, which is usually provided by the management team but not by the PE seller.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

The use of representations and warranties insurance is significantly increasing in Spain, particularly in auctions or competitive bid acquisition processes.

Any parameter of the insurance policies is determined by each insurance company considering the coverage needed, the characteristics of the transaction and the target company. However, to provide an estimated average of the market, the policy limit ranges between 10% and 20% of the target's enterprise value, the deductible is fixed between 0.5% and 1% and the recovery policy period is generally seven years.

Insurance premiums vary depending on the target company, the insurer's associated costs, the coverage requested and the timing of the transaction among other factors, but usually range between 0.5% and 2% of the policy limit.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

PE sellers usually cap their liability at a percentage of the price (between 5% and 20%) and for a period of up to two years from closing, except for matters such as tax, labour, social security, personal data protection or environmental matters which are usually subject to their relevant statutory limitation periods (i.e. four to five years). Warranties are usually provided for specifically identified potential liabilities or to cover any potential damages arising from the breach of the representations and warranties or any covenant agreed in the share and purchase agreement. The extension of the definition of damages is also negotiated and limited to the item provided for in the Spanish Civil Code.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

As mentioned, escrow accounts are the most common warranties granted by PE sellers. These warranties are usually requested by buyers to cover certain potential liabilities and ensure retention and faster access to the seller's money, although they are monetarily limited to a percentage of the purchase price, limited to a period of time, and partial releases of the amount deposited need to be agreed between the parties.

Except when the management team are also selling shareholders, they rarely grant warranties in PE transactions.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

In Spain the most common scenario is the buyer providing the seller with an equity commitment letter which sets forth the availability of

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debt and/or equity finance. Staple financing or a pre-arranged financing package offered to potential bidders for an acquisition and arranged by an investment bank is not yet common.

Where equity finance is required, the commitment letter is usually provided by the PE funds controlling the companies. Where debt financing is required such letters (usually of a soft nature) are issued by financial entities, although they are in general subject to the fulfilment of certain conditions: confirmatory due diligence; final agreement on contractual terms and conditions; and no material adverse change occurrence.

In the absence of compliance by the buying entity, sellers have the right to request specific performance of obligations under the commitment letter and/or to be indemnified for the damages caused. However, due to the soft nature of the letters and since they are commonly subject to certain conditions precedents, it may be difficult to obtain their enforcement.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are relatively unusual in PE transactions in Spain because they are difficult to negotiate and enforce in case of breach.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

No particular features and/or challenges shall concern PE sellers in considering an IPO exit, further than those applicable by law to any other seller.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

They are imposed for 180 days with a possibility to be increased up to 360 days depending on the participation that the PE investor might still have remaining in the target company after the IPO exit.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Dual-track exit processes are not implemented in all transactions, but can be seen in Spain, particularly in large deals and when the IPO market is favourable.

PE sellers can continue to run the dual-track exit process until pricing, but it usually depends on the particularities of each transaction. In Spain, both sales and IPOs have turned out to be successful, so both structures have the same possibilities to be ultimately realised.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Bank financing and direct lending (vendor's loans or direct financing at the target company) are the most common sources of debt in the Spanish market. Direct lending gained importance during the economic and financial crisis as an alternative financing tool when banks were not providing enough liquidity. Additionally, some mezzanine debt funds are very active in the Spanish market providing financing facilities where the traditional financial entities do not reach or cover the needs of the transaction.

The combination of both banking financing and alternative financing has proved interesting since it allows for far more complex and flexible structures, with higher returns. This is typically applied in hybrid structures where debt funds not only provide equity but also debt.

Lately, with the recovery of the Spanish economy, the high-yield bond market has returned, with attractive yields and a low-risk premium.

Thus, despite the high dependence on financing from traditional banks, the trend for Spanish corporates is to actively seek alternative financing.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

Financial assistance (that is, to advance funds, extend credits or loans, grant security, or provide financial assistance for the acquisition of its own quotas or shares) is the main legal restriction under the LSC.

Additionally, there are some tax limitations imposed to tax deductibility of interests (as further explained in section 9 below).

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

As mentioned in question 8.1 above, although financial entities and banks are offering liquidity and lower interest rates, in the last two years the Spanish market, driven by a macroeconomic positive environment and a record of PE transactions in 2017 and 2018, has observed a significant increase in direct lending from funds.

Thus, both bank financing and direct lending co-exist providing investors and companies with a diversified menu of debt structures.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Unless the investor is resident in a tax haven, income obtained by non-resident investors in Spanish PE-regulated vehicles (both

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dividends and capital gains derived from the transfer of shares in the Spanish PE) is not subject to taxation in Spain.

Subject to the investor tax residency, interest income obtained by non-resident investors could be subject to Withholding Tax (except if the lender is an EU resident). Other types of vehicles require careful planning to facilitate efficient cash-back channels to investors.

Off-shore structures are also common in Spanish PE deals. However, it is important to undertake a particular analysis of certain tax issues like the tax deductibility of the interest expense incurred by the Spanish entity acquiring the target and the tax consolidation regime. The participation exemption regime also applies to domestic investments when the shareholding in the target is higher than 5%, that is, dividends obtained by Spanish entities from Spanish subsidiaries are exempt from Corporate Income Tax ("**CIT**"). Likewise, capital gains obtained by Spanish entities from the transfer of Spanish subsidiaries are exempt.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

It is common practice for the management team to receive incentive packages based on risk-sharing principles and the maximisation of value at exit. Considering tax-efficiency reasons, management teams usually focus their attention on: (i) sweet equity or ratchets; (ii) payments of deferred bonus (which may enjoy certain reductions for tax purposes if generated in a minimum period of time); or (iii) stock appreciation or similar rights ("**SAR**").

As the management team also holds a minority stake in share capital of the target company, capital gains upon exit would be generated in the same way as the financial investors, and would be subject to the 23% Personal Income Tax rate, which is lower than the taxation of the income received as employment remuneration. Likewise, ratchet payments upon exit up to EUR 300,000 may benefit from a 30% tax reduction provided for gains accrued in periods longer than two years.

Nevertheless, there is a certain discussion about the taxation of these instruments and their risk of re-classification, due to the wide definition of "salary" or "work-related-income" for tax purposes, and the already existing anti-avoidance rules (e.g. any assets, including securities or derivatives, acquired by an employee below market price are deemed to be "salary" from a personal income tax point of view).

Recently, an amendment has been introduced in the relevant applicable regulations in one of the territories of the Basque Country (in Guipuzcoa) to clarify and provide certainty to managers in connection with the taxation of the carried interest. The goal of this amendment is to align and to clarify that, if certain conditions are met, carried interest will be taxed as a capital gain or income on movable property, rather than as employment income. This also follows a recent trend in other EU jurisdictions.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

As mentioned in question 9.2, capital gains at exit are generally subject to Personal Income Tax at a 23% marginal tax rate.

The main tax consideration in the reinvestment of part of the management team's investment into a new acquisition structure is that the exchange is qualified as tax-neutral. However, recent tax audits and court resolutions have denied the application of the tax neutrality regime to exchanges of shares in certain cases. To apply for the tax neutrality regime in share-for-share exchanges, the issuer of the new shares (i) should hold more than 50% of the share capital in the target company as a result of the exchange, and (ii) cannot pay more than 10% in cash.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

Other than the amendments in the Guipuzcoa regulations on carried interest taxation, no other significant changes in the tax regulation applicable to PE have occurred in 2018.

As a result of rules introduced in 2015 on the deductibility of interest expense for CIT purposes, the Spanish tax authorities have focused on indebtedness borrowed by Spanish CIT-payers (specially, intra-group loans) and its impact on the payment of taxes. The allocation of expenses to target companies on the transfer of companies is also a common area of discussion, as well as transfer pricing.

Also, the focus has been on indebtedness borrowed to finance the distribution of equity or to finance the repurchase of own shares when, in the opinion of the tax authorities, the financing does not present a direct link with the generation of income by the target companies.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

After the intense legislative activity undertaken in 2014 and 2015, no significant new legislation affecting PE investments has been enacted or amended in 2018.

Notwithstanding, it is worth mentioning that on September 29, 2018, the Spanish Securities Market Act ("**LMV**") amended to partially transpose the provisions of Directive 2014/65/EU of the European Parliament and of the Council of May 15, 2014 on markets in financial instruments ("**MIFID II**"), which impact on the management companies and impose additional requirements especially in the commercialisation of funds.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

As stated in question 4.1 above, PE transactions are not subject to any prior authorisation unless the company is engaged in a regulated sector or the transaction results in a concentration of companies that exceeds certain antitrust thresholds.

Foreign investments and divestments in Spanish companies must, however, be communicated to Spanish authorities but for FDI statistical purposes only.

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10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

Due diligence work is a process to be performed thoroughly, since the report usually covers an extensive analysis of the potential acquisitions from several perspectives including legal, financial, tax, commercial, technical, regulatory and compliance.

However, red-flag reports, sample-based due diligence and materiality thresholds are common as well. It is generally conducted by outside advisors specialised in each area. The usual timeframe covers a four-week period, depending on the commitment and resources devoted by each party and the technology used in the process.

Publicly traded companies are normally exempt of due diligence work.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

PE sellers are increasingly concerned with compliance with anti-corruption and anti-bribery regulations. PE companies are incorporating internal compliance officers primarily focused on undertaking extensive and carefully supervised AML due diligence every time the entity approaches a potential investment.

Further, compliance provisions are becoming increasingly usual in investment agreements (particularly as a representation to be provided by the selling shareholders) and/or shareholders' agreements.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

There are two circumstances under which a PE investor could be held accountable for the liabilities of the underlying portfolio companies: (i) if the PE investor is considered as a company "shadow director"; or (ii) if the court lifts the corporate veil of the portfolio company and, consequently, the action or omission for which a liability has risen is attributed to the PE investor.

Otherwise, under Spanish law, a portfolio company (nor its directors, officers or employees) cannot be held accountable for the liabilities of another portfolio company.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Most of the relevant factors that a potential PE investor must consider when approaching a Spanish investment have already been addressed in the previous sections. As in any other economy, legal certainty, political stability, foreign exchange rates, labour and union regulations and other rights become major considerations to investment in our jurisdiction.

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Prior to joining Garrigues in 1999, he was an associate in the corporate and business law department of another international firm.

He graduated from the Autonomous University of Barcelona where he completed a specialisation in European Community Law. Later, he obtained his LL.M. in International Economic Law (*honors*) from Howard University School of Law in Washington D.C. and supplemented his studies by completing a postgraduate programme at Harvard Law School. In 2005–2006, he worked as an associate in the M&A department of Skadden, Arps, Slate, Meagher & Flom, LLP, in New York.

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Our PE teams sit in the main offices of the firm's extensive Spanish and international network, thereby finding the right blend between specialist expertise and local market knowledge. The PE group works in close collaboration with other industry specialists, ensuring optimum quality and tailor-based analysis for each acquisition and for each investor.

Our PE practice covers areas such as setting-up funds, acting on behalf of management teams and investors, advising transactions in seed or venture stages, LBOs or MBOs and funds of funds transactions.

Our experience accumulated in the sector has made Garrigues one of the leading providers of tax and legal services to PE firms, LPs, GPs and other industry players. Garrigues M&A and PE partners are highly and consistently recognised by the most prestigious rankings and international legal directories and by their clients.

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Sweden

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

The Swedish Private Equity (PE) market remains active and the amount of PE transactions involving Swedish targets and/or Swedish PE fund managers continues to be high.

Infrastructure and engineering/manufacturing-related deals have traditionally been frequent on the Swedish transaction market. In respect of the number of PE transactions, the wholesale and retail, consumer goods (herewith consumables), professional services, financial institutions and technology (internet-based services, fintech, medtech, biotech and gaming) sectors have also dominated the Swedish market. Due to a threat of an increased regulatory burden on target companies in the publicly funded healthcare and educational sectors, the PE players have, in recent years, not made new platform investments in these sectors. Instead, they have focused on exiting their current holdings by IPO or selling their shares to long-term institutional investors.

A majority of the Swedish PE players focus on mid-cap target companies. In general, the target companies are exited through trade sales, secondary buyouts and IPOs. Controlled auctions are still quite commonly used in PE transactions involving non-public target companies.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

The Swedish transaction market in general remains active, fuelled by low interest rates and an abundance of capital invested in PE funds. The good market conditions, in combination with a stable financial system providing relatively inexpensive financing and an un-bureaucratic legal system allowing foreign and domestic investments, have allowed for a strong transaction market. The PE industry is, furthermore, quite mature, well-known and, in many ways, trusted in Sweden.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

As the number of players on the Swedish PE market is increasing and, with that, the competition for attractive investment targets, PE houses are, to an increasing extent, attempting to differentiate themselves through specialisation and access to specialist industrial advisers in order to be able to add industrial and operational know-how to their portfolio companies.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Today, virtually all national and international PE funds with Swedish activity are organised as some type of limited liability partnership, wherein the institutional investors participate as direct or (normally) indirect limited partners, and wherein the fund manager acts as the general partner, normally owned through a private limited liability company specifically organised for this purpose.

Funds organised under Swedish law will, when investing into Swedish target companies, normally adopt a one-tier structure by investing through a set of Swedish holding companies. However, funds organised under a foreign jurisdiction investing in Swedish target companies will usually structure the acquisition by adopting a two-tier structure, irrespective of whether the manager is foreign or domestic.

Normally, the acquisition of the shares in the Swedish target company will be made by the foreign or domestic holding structure through a Swedish-incorporated and tax-resident special purpose vehicle (SPV) that eventually acquires the target company. Additional (Swedish and foreign) holding companies could be added into the structure to allow for flexibility in obtaining subordinated debt financing and for other tax and commercial reasons.

Due to public pressure and new tax legislation, several large Swedish PE fund managers have announced that they contemplate setting up their new funds onshore. Further, due to the increased regulatory burden, the smaller Swedish PE players focusing on mid-cap and small-cap targets are starting to arrange alternative investment structures in the form of pure investment companies.

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2.2 What are the main drivers for these acquisition structures?

The main drivers relate mainly to tax purposes and the debt providers' requirements on the debt and equity structure of the acquisition holding company structure.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

The equity is generally structured by way of ordinary shares and preference shares. The envy ratio is normally linked to the expected return (set out in the business plan/investment case) and the expected value creation generated by the general partner and management respectively.

The carried interest is typically managed on fund level and calculated on the basis of the whole fund. However, there are funds calculating the carried interest on the basis of separate deals, or a mix thereof. The carried interest entitlement normally arises after investors have received return above a predetermined hurdle rate.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Historically, PE investors rarely took minority positions but this has changed in recent years as there is an increased tendency to do so. If they do, the shareholders' agreement will typically include governance provisions, right of board participation, information rights, veto rights, anti-dilution provisions, share transfer restrictions (binding the founders) and exit provisions such as drag-along and tag-along rights.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Compensation arrangements provided by PE investors typically include management incentives shares in the SPV used to make the offer (or a holding company directly or indirectly owning the SPV). Usually, strong transfer restrictions apply to the incentive shares through an accession to a shareholders' agreement. The management typically need to sell back their shares to the majority investor for a purchase price corresponding to the market value, if they are good leavers, or at a discount if they are considered bad leavers (e.g., if they commit a material breach of the shareholders' agreement, are dismissed for cause or choose to leave the company). Drag-along and tag-along provisions are normally present to enable a smooth exit process.

Eligible for the equity participation are, typically, tier 1 management, including CEOs and CFOs. The equity offered to management most often comprises common and/or preference shares (including coupon) with a different return structure. Depending on the size of the deal, sweet equity pots would be set aside to management ranging from 10–15 per cent to as low as 3 per cent in large deals, allocated between the different layers of management in agreed proportions with the CEO often being granted around 30 per cent of the pot.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Good leavers would normally be those who are terminated by the employer without cause, due to long-term illness or retirement. Bad leavers are normally those who terminate their employment voluntarily within a set period of time after their investment, who are dismissed from their employment based on personal grounds or are summarily dismissed based on gross misconduct or those who are in breach of the terms of the shareholders' agreement (including non-compete undertakings).

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

The typical governance arrangements for PE portfolio companies are the shareholders' agreement entered into by the sponsor and management (containing provisions regarding governance, information undertakings and share transfer restrictions) and the company's articles of association (containing capital structure, corporate governance and share transfer restrictions). The shareholders' agreement is not public and only the parties to the agreement are bound by its provisions. The company's articles of association are publicly available and also binding to third parties (and the company itself).

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

The PE investor often holds the majority of the shares in the portfolio company and is therefore able to control important corporate decisions in the company through its voting rights. If the PE investor does not hold a controlling stake, it will implement a veto (or reserved matters) list in the shareholders' agreement concerning the appointment of the CEO, new acquisitions and disposals, anti-dilutive measures, approval of the business plan and annual budgets, new investments outside of the business plan, etc.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

Only the parties to the shareholders' agreement are bound by its provisions. The shareholders' agreement is not enforceable against the company itself, its representatives or third parties. The company, its representatives and third parties are, however, bound by the provisions in the articles of association.

The company representatives (e.g., the board and CEO) owe fiduciary duties to the company (and all shareholders jointly) that supersede the instructions provided by the shareholder appointing the director. A director might therefore disregard the veto rights and instructions provided by the shareholder appointing him.

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As a result, some funds seek to cater for such risk by implementing detailed governance provisions in the companies' articles of association and entering into separate consultancy agreements with the directors appointed by them (containing sanctions if the board representative does not vote in accordance with the investor's instructions).

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

Under Swedish law, a controlling shareholder is free to act in its best interest and does not have any duties as such towards a minority shareholder. However, the Swedish Companies Act contains various minority protection provisions. As a general principle, all shareholders should be treated equally, meaning that the majority investor may not implement decisions for its own benefit to the detriment of other shareholders, and new share issues that are not offered *pro rata* to the current shareholders require the support of a qualified majority etc. There are also certain specific minority protection clauses, e.g., entitling the minority to appoint an additional auditor and implementing a special scrutiny of the board's administration of the company. The parties typically agree in advance on how to handle, e.g., value transfers and share issues through the shareholders' agreement. However, provisions generally disallowing the minority investors to use their mandatory minority protection through provisions in the shareholders' agreement are not enforceable.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Shareholders' agreements are enforceable under Swedish law but, as mentioned in question 3.3, the agreement is only binding between the parties and not enforceable against the company or third parties. If a shareholder commits a breach under the shareholders' agreement, the non-breaching party may seek contractual damages from the breaching party, but the breach will not affect the validity of corporate resolutions adopted in breach of the shareholders' agreement. Provisions that are contradictory to mandatory law, e.g., minority protection rules, are not enforceable under Swedish law.

Both non-compete and non-solicit provisions are common in a shareholders' agreement. The provisions need to be reasonable and fair, meaning the provisions may not be extended for an unreasonable period of time after a party is no longer a shareholder (typically a period of up to two years is deemed reasonable – but it can be up to five years if there are special circumstances) and/or without reasonable compensation.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

The investor should be aware that at least half of the board members in a Swedish limited liability company should be residents of the EU/EEA. Furthermore, the directors are not bound by the shareholders' agreement. Instead, the directors of a Swedish company have a fiduciary duty to act in the best interest and care of the company and are responsible for the organisation and the management of the company's affairs, including its financial position. A director or managing director, who, in the performance of his or her duties, intentionally or negligently causes damage to the company, fails to pay due taxes or assists in respect of, e.g., unlawful value transfers shall compensate such damages. This liability is personal for the director and will not be transferred to the PE investor merely for appointing the director. If the investor, however, has instructed a director (or other shareholders) to execute unlawful value transfers, such transfers may be recovered by the company under customary claw-back provisions in accordance with the Companies Act. Customary D&O Insurance will normally be provided to directors appointed by PE investors.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

As mentioned in previous questions, the directors have a fiduciary duty to act in the best interest of and care for the company. A member of the board may therefore not participate in a specific matter regarding an agreement between the board member and the company, an agreement between the company and a third party, where the board member in question has material interest which may conflict the interest of the company, or an agreement between the company and a legal person which the board member is entitled to represent, whether alone or together with another person. Often, an independent director is also appointed so that the board as a whole will not be disqualified in matters relating to the relevant shareholders.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

Except for competition clearance, corporate transactions in general do not require consent from Swedish authorities, hence regular share purchases can be completed in accordance with the time schedule agreed upon by the parties.

If the target company operates within certain regulated industries, there may be specific requirements to consider (such as requirements for public permits and approvals). Such industries are, e.g., financial institutions, infrastructure, media and defence.

Timing and speed of the work stream for financing discussions also impact the timetable. The time required for such discussions will normally be heavily dependent upon the complexity and size of the deal, as does the time required to establish the desired investment vehicles and to prepare the exit of the target company.

The issues influencing the timetable for going-private transactions in Sweden will, in general, be similar to those above. However, the time necessary to prepare and receive approval of the offer document, the target's board to evaluate the offer and any alternatives to the offer period, conduct squeeze-out of the minority shareholders, etc. also need to be considered.

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4.2 Have there been any discernible trends in transaction terms over recent years?

Recent trends in Sweden are the increase in deals involving Warranties & Indemnities (W&I) insurance and the "locked box" purchase price mechanism being the prevailing purchase price mechanism.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

There are no particular features or challenges applied specifically to PE investors.

In a going-private transaction involving companies listed on a Swedish regulated market, the Takeover Act and the particular exchange's Takeover Rules may apply, imposing restrictions and rules that must be complied with throughout the transaction.

To address the risks associated with shareholder dissent, the acquirer prepares and structures the transaction accordingly. Firstly, the acquirer may seek the pre-approval by the target's board of directors for their recommendation to its shareholders and further secure conditional or unconditional acceptances from major shareholders of the target company.

Secondly, due preparations with respect to due diligence of the target company and preparations with respect to financing and other key conditions are conducted to mitigate the risk of revaluating or declining the offer.

In a going-private transaction, the bidder may include a financing condition in its offer. However, such condition may not relate to equity financing and could effectively only be invoked should the financing banks fail to fulfil their obligations under the relevant loan agreement. The debt financing for a takeover bid therefore typically includes "certain funds" language, meaning that the lenders may not refuse to make available acquisition facilities unless a default occurs due to circumstances within the bidder's control.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

Under Swedish take-over rules, a target company is not allowed to enter into any binding-offer related arrangements with the offeror, except for confidentiality undertakings and no-solicitation undertakings with respect to employees, customers or suppliers. This means that typical deal protection measures, such as break-up fees and arrangements to procure exclusivity, are not permitted. It is possible to apply for an exemption from this restriction with the Swedish Securities Council, but such exemptions would only be granted under specific circumstances, such as if the arrangement would be part of a merger between equal parties and undertakings between the parties would be mutual.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

For both PE buyers and sellers, a "locked box" purchase price mechanism is preferred, often based on an enterprise value, less net debt calculation on the basis of audited or non-audited monthly or quarterly reports. The "locked box" mechanism offers certainty in the purchase price, avoids post-closing adjustments and potential disputes in relation thereto, and enables prompt distribution of sale proceeds to investors and sellers after closing. When a "locked box" mechanism is used, it is common that an interest component is introduced, compensating the seller for the expected cash flow generated by the business between the "locked box" date and closing. Depending on the seller, it is not uncommon that part of the purchase price is paid by issuing consideration shares in the SPV, or that a part of the purchase price is financed by the seller through a vendor loan note.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

Since the PE sellers usually wish to distribute the transaction proceeds as soon as possible and with high foreseeability, they typically only provide fundamental warranties such as title capacity and authority and absence of certain events (prior to closing) warranties. In recent years, the introduction of cost-efficient W&I insurance policies has, however, allowed PE sellers to provide a wider range of warranties.

Management might provide more extensive warranties than the PE seller but usually all sellers are treated equally in the purchase agreement, mainly due to customary drag-along provisions under the sellers' shareholders' agreement where equal treatment is normally a general rule.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Restrictive covenants including how the business is run between signing and closing, and non-competition/non-solicitation covenants up to two to three years following the transaction are common. PE funds are usually restrictive in giving non-competition/non-solicitation covenants depending on the fund structure and holding of portfolio companies, however, management normally provides such covenants to the buyer.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

As mentioned in question 4.2, W&I insurance is nowadays a tool used very frequently in Sweden, providing clean exits for sellers and minimising time spent on negotiating warranties, bridging the gap between the seller and the buyer and enabling the PE sponsor to distribute the proceeds to its investors immediately after closing. However, areas which have not been sufficiently covered by the due

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diligence, known risks and disclosed matters are excluded from the insurance policy. Typical exclusions include environmental matters and transfer pricing issues which may require a special insurance policy to be fully covered. The cost of insuring is typically around 1.2–1.5 per cent of the policy limit.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

There are several standard limitations to the warranties, including limitations in time, baskets and caps, exclusion of deductible items and exclusions for information provided during the due diligence process.

Fundamental warranties, such as title capacity and authority, absence of certain events (ordinary course) and no leakage covenants, are excluded from *de minimis* and basket thresholds and typically subject to a cap corresponding to the purchase price. Business warranties and other covenants are often capped at around 10–30 per cent of the purchase price.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

PE sellers typically reject to provide an escrow to cover potential claims due to their interest to distribute the proceeds to the PE investors as soon as practicable after closing.

As mentioned above, PE buyers and sellers more often secure themselves by W&I insurances by shifting the risks to a third party. Other ways for PE buyers to secure themselves against counterparty risks are by requesting escrow accounts and guarantees/undertakings from the sellers in the share purchase agreement.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

PE buyers often have to prove to the seller that financing of the purchase price was obtained through confirmation from the proposed debt provider prior to entering into a purchase agreement. The buyer also normally provides the seller with an equity commitment letter guaranteeing drawdown of sufficient equity from the fund, or the fund's investors, to cover the remaining part of the purchase price due by the SPV. Enforcement rights for the sellers are typically obtained by way of giving the sellers rights to act on behalf of the buyer subject to the satisfaction of the conditions to closing.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are not prevalent in Swedish PE transactions; they do, however, occur under special circumstances.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

The starting point related to the shares in a going-public transaction is to dissolve all rights and restrictions related to the shares, including internal restrictions such as within a shareholders' agreement and external restrictions such as within the company's articles of association. All rights in violation of applicable market rules must be dissolved, of which the board appointment rights are one of the central subjects of discussion if a majority shareholder retains its majority position post the initial offering.

The Swedish Corporate Governance Code sets out rules applicable to companies listed on a regulated market, under the principle of "comply or explain". Several of the rules in the Code seek to improve transparency within public companies, by, e.g., prescribing a certain composition of independent directors of the board and the requirement to annually publish a corporate governance report. The measures needed to be taken under the Code, from the moment of going public on a regulated market, impose additional costs and administrative burden on companies and their boards of directors.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

Lock-up restrictions may apply depending on the transaction and the function and demand of the appointed advisers, whether book runners, underwriters or the recommendation of any other financial adviser. If the owners are considering a full exit of their holdings, a lock-up period will mitigate the price drop of a sudden disposal. If a financial adviser is acting as an underwriter, they would normally not be willing to take on the associated price risk of such sudden disposal upon listing. A lock-up period of at least six months or a year would be common in such case.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

A dual-track process allows the PE sponsor to keep its options open and pursue the exit route offering the most attractive return and providing the most favourable terms. The dual-track process is normally run until the end of the sale process and aborted just prior to execution.

In recent years, the Swedish public market has been subject to high valuations. Many of the PE target companies have therefore been exited through an IPO.

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8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

The typical debt financing of a PE transaction in the Swedish market combines (two or more of) subordinated shareholder and/or vendor debt which is treated as equity for ranking and covenant purposes, mezzanine or junior high-yield bond debt and senior bank loans. Mezzanine debt is not as commonly used as pre-crises, whereas the market for high-yield bonds and debt funds offering unitranches has seen a significant development in the past few years. Bridge-to-bond financing structures with the bank as a supersenior lender are also seen in larger deals. However, it is not common to finance a PE transaction with bond financing already at completion.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

There are no legal requirements or restrictions that particularly affect a PE investor's choice. However, Swedish law contains financial assistance rules which prohibit the provision of loans and granting of security or guarantees with the purpose of financing an acquisition of shares in the lender or grantor itself or its parent or sister company. There is no whitewash procedure under Swedish law; however, the prohibition on financial assistance is not perpetually linked to a certain loan (differing from, e.g., Norwegian law). Therefore, a target company or its subsidiaries cannot provide cash loans, security or guarantees in direct relation to an acquisition of said target. However, the target group may provide security and guarantees after a period of time.

The granting of security and guarantees by a target or a subsidiary under Swedish law is further subject to restrictions on distributions, certain prohibited loans and the purpose of the company's business. Whether and to what extent such restrictions apply, and how they are dealt with, requires analysis on a case-by-case basis. Generally, however, a limitation language to address these issues is inserted in any relevant security or guarantee document.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

New lenders have entered the market recent years offering an alternative to mezzanine debt and also as an alternative to the bank's term loans. Mezzanine structures have declined due to pricing and the entry of new competitors with lower requirements for the credit position. Among new lenders which have entered the market, we see private and public pension funds, insurance companies and other players outside the traditional financing sector. These new direct lenders often accept to be more deeply subordinated to the bank's claims than what the mezzanine funds accept.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

The vast majority of transactions in the Swedish PE market are conducted through share deals since a share deal is normally tax-exempt for the seller under the Swedish participation exemption rules.

A Swedish acquisition company may be established in order to allow for the taxable income of the Swedish target group to be offset against interest payments related to the acquisition and, provided the acquisition company holds more than 90 per cent of the shares in the target company, tax consolidation may be achieved. Under the Swedish participation exemption rules, a Swedish holding company may also sell the shares in a Swedish wholly-owned subsidiary tax-exempt.

Offshore structures are still quite common. Structures involving Swedish target companies typically have a Swedish holding structure, owned by a foreign holding structure (typically one or two Luxembourgian or Channel Islands holding companies) that, in turn, is owned by the fund. In recent years, however, due to the decreasing tax benefits, the regulatory burden and public opinion against offshore structures, many newly founded PE funds focusing on Swedish target companies have been established employing an onshore structure.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Management incentive programmes in Swedish target companies are often structured so that management is offered to invest in the fund/target companies through an instrument that will qualify as a security (typically subject to capital gains taxation) for Swedish tax purposes (shares, warrants, convertible bonds, and profit participation loans). In order to lower the initial investment, management may be offered to invest in the highly debt financed acquisition company. An alternative may be to issue warrants or to use different types of share classes. In order to avoid a tax exposure, it is important to make a third-party valuation of the instruments offered to management and to ensure that the instruments are not subject to restriction more severe than has been accepted in case law.

In general, all types of salaries and benefits (including acquisition of shares below market value) and incentive instruments not qualified as securities (but rather as employee share options) provided to an employee are considered employment income taxed with progressive tax rates. Salary and benefit costs are also subject to social security contributions for the employer which is, however, a deductible cost for the employer.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

Important tax considerations for a Swedish management team in an exit would be their individual tax treatment in relation to their proceeds, and in relation to their roll-over in order to obtain a tax neutral exchange of shares by deferring taxation until exit.

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9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

As regards the PE fund structures, the main tax issue during recent years has been the taxation of carried interest. The Swedish tax agency has previously considered that the carried interest should be considered as a salary for management in PE funds. The Swedish tax agency, however, lost these court cases and is now trying to tax the carried interest according to the Swedish rules regarding so-called closely held companies. The effect of applying the rules on closely held companies is that a portion of the carried interest should be taxed as a salary income (up to approximately 58 per cent tax) instead of a capital gain (25–30 per cent tax). We expect to see continuous discussions and cases regarding taxation on carried interest.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

In 2013, Sweden implemented the EU AIFM directive through the AIFM Act. The AIFM Act has made a number of previously unregulated funds, including PE funds, subject to regulation. The AIFM Act requires the manager of an alternative investment fund to, among other things, comply with rules related to conflict of interests, risk management, liquidity management, organisational requirements, valuation procedures and rules restricting delegation of functions. In addition, the AIFM Act contains rules for cross-border marketing of alternative investment funds within the EEA to professional investors.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

PE investors are not subject to any enhanced regulatory scrutiny. Within certain industries or sectors, there may be specific regulatory requirements for permits or approvals to be considered. This may include targets in, e.g., the financial, insurance, energy, media, infrastructure and telecom sectors.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

The PE sponsor often wants to conduct a rather thorough due diligence with a focus on the material risk of the target company's business. Scope, timeline and materiality thresholds depend on the business of the target company. The increase in W&I insurance in Sweden has affected the scope of the due diligence since the PE buyer will need to examine all areas included in the insurance policy. External counsels are typically engaged for legal and compliance matters and the report format is often a "red flag" report summarising the material issues and risks with suggestions on how to address such issues.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

The regulatory burden, as well as the public opinion, has caused the PE players to focus on CSR, ESG (Environmental, Social and Governmental) matters, including, e.g., anti-corruption. Due diligence is conducted to ensure compliance with applicable laws and identify potential risks and liabilities relating to the target company. Contractual protection to limit any risks and liabilities relating to ESG matters is becoming standard.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Since the portfolio company is a separate limited liability company, it is extremely rare that a PE sponsor is held liable for the portfolio company's obligations. The "corporate veil" will only be pierced following an unlawful value transfer or due to extremely hazardous activities in a deliberately under-capitalised portfolio company.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

The Swedish PE market, especially concerning mid-cap target companies, is considered strong and is one of the largest in Europe (measured in terms of its share of GDP). Buyers and sellers (and their advisors) are quite accustomed to PE sponsors and their concerns, which facilitate efficient deal execution and structuring. Furthermore, the Swedish legislation is investor-friendly and generally allows foreign as well as domestic investors to buy and sell Swedish companies without going through unnecessary bureaucratic processes.

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TÖRNGREN MAGNELL

Törngren Magnell is known as a premier transaction law firm in Sweden and was established in 2006. The firm is located in Stockholm and assists in both domestic and cross-border transactions. The lawyers have previous experience from top-tier law firms, public companies and leading international audit firms.

Private equity and venture capital are key industry sectors for Törngren Magnell. Our financial investors team has built a strong reputation in the Swedish marketplace and understands what private equity and other financial investors require for successful deal execution. We have considerable experience advising on all types of transactions, from start-ups and venture capital investments to large and complex cross-border private equity deals, from the initial investment all the way to exit (whether as an IPO or a trade sale).

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Switzerland

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

All of the standard transaction strategies to acquire portfolio companies are commonly used in Switzerland. We assume that regular leveraged buyouts have accounted for the majority of the transactions in recent years. In 2018, private equity funds were involved in around one-third of the transactions in Switzerland.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

Although M&A levels have remained high in recent years, they continued to increase in 2018, with private equity transactions reaching a 10-year high. Low interest rates for transaction financing as well as favourable borrowing conditions have generated an incentive for high levels of private equity activity.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

While several voices predict a slow-down of M&A activity in the near future, we have not experienced this so far and remain optimistic that 2019 will continue to show a solid volume of M&A activity.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

Usually, private equity funds investing in Swiss portfolio companies set up a NewCo/AcquiCo in Switzerland as an acquisition vehicle. The NewCo is held either directly or via Luxembourg, Netherlands or a similar structure. We have also seen AcquiCos incorporated outside of Switzerland.

Management usually invests directly in the AcquiCo rather than via a management participation company. Often, a single shareholders' agreement (SHA) is concluded between the financial investor(s) and management, which governs all aspects of the investment (governance, exit procedures, share transfers, good/bad leaver provisions, etc.). In other cases, a main SHA is concluded between the financial sponsors and a separate, smaller SHA with management.

2.2 What are the main drivers for these acquisition structures?

The acquisition structure is mainly tax-driven (tax-efficient repatriation of dividends/application of double taxation treaties, tax-exempt exit). Directly investing in the AcquiCo may allow Swiss-domiciled managers to realise a tax-free capital gain on their investment when the AcquiCo is sold on exit.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

A Swiss NewCo often has only one class (or a maximum of two classes) of shares. Preferential rights, exit waterfall, etc. are implemented on a contractual level in the SHA. NewCos incorporated abroad often have several classes of shares.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Structuring is, in principle, not fundamentally different from majority investments. Pre-existing structures are often maintained to a certain extent. However, on a contractual level increased protection is sought (veto rights, right to trigger an exit).

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Management equity amounts and terms depend very much on the individual deal. Typically the management stake ranges between 3–10%. In most cases, standard drag and tag provisions and good/bad leaver call options for the benefit of the financial sponsor will apply. Put options for the benefit of management are less prevalent.

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2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Good leaver cases typically encompass (i) termination of employment by the company absent cause set by the manager, (ii) termination of employment by the manager with cause set by the company, and (iii) death, incapability, reaching of retirement age or mutual termination.

Bad leaver cases on the other hand usually include (i) termination of employment by the company with cause set by the manager, (ii) termination of employment by the manager absent cause set by the company, and (iii) material breach by the manager of the SHA or criminal acts.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

The predominant model for acquisitions of portfolio companies in Switzerland is the stock corporation (*Aktiengesellschaft*). Sometimes, limited liability companies (LLCs, GmbH) are used, which have the advantage of being treated as transparent for US tax purposes.

The stock corporation is governed by a board of directors which has a supervisory function and resolves on strategic and important issues (appointment of senior management, etc.). A director is elected *ad personam*; proxies (e.g. in the case of absence at meetings) are not possible.

Day-to-day management is normally delegated to management, based on organisational regulations. They often contain a competence matrix defining the competences of each management level and the decisions which need approval by the board or even shareholders.

Such division of competence is – together with board composition, quorum requirements, etc. – also reflected on a contractual level in the SHA.

Neither the organisational regulations nor the SHA are required to be made publicly available in Switzerland; only the articles of association.

Our comments in question 3.1 regarding stock corporations apply largely also to LLCs.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

If a private equity investor holds a minority of the voting rights, its veto rights usually depend on the stake held, while a small investor (up to 20%) normally enjoys only fundamental veto rights aimed at the protection of its financial interest (dissolution, *pro rata* right to capital increases, no fundamental change in business, maximum leverage, etc.); investors holding a more significant minority stake (20–49%) usually also have veto/influence rights regarding important business decisions and the composition of senior management. The exit rights for private equity investors holding a minority position are usually heavily negotiated.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

At shareholder level, veto rights may be created by introducing high quorums for certain shareholders' decisions in the articles of association and the SHA. Such veto rights are generally regarded as permissive as long as the arrangement does not lead to a blockade of decision-taking in the company *per se*.

At board level, individual veto rights of certain board members cannot be implemented based on the articles of association or other corporate documents. However, such individual veto rights are regularly incorporated in the SHA; i.e. the parties agree that the board shall not take certain decisions without the affirmative vote of certain nominees. A board decision taken in contradiction to such contractual arrangement would still be valid but may trigger consequences under the SHA. Furthermore, directors are bound by a duty of care and loyalty *vis-à-vis* the company. If abiding by instructions given by another person based on contractual provisions leads to a breach of such duties, the board member may not follow such instructions and will likely not be in breach of the SHA (at least if the latter is governed by Swiss law).

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

Purely from its position as a shareholder, in principle, a private equity investor does not have such duties; shareholders of a Swiss stock corporation do not have any duty of loyalty.

However, directors, officers and management have a duty of care and loyalty towards the company and, to a certain extent, also to the minority shareholders. Under special, limited circumstances, a private equity investor or an individual acting for it may be regarded as *de facto*/shadow director of the company and, consequently, also be bound by such duties. The claim that a shareholder or one of its representatives is a shadow director might be successfully made if such person has *de facto* acted as an officer of the company, e.g. by directly taking decisions that would actually be within the competence of the board, etc.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

SHAs are common in Switzerland and are normally governed by Swiss law. The parties are largely free to determine the rights and duties but there are certain limitations. The most important ones are:

- a SHA may not be unlimited in time/valid during the entire lifetime of the company, but may have a maximum term of ca. 20–30 years; and
- as per mandatory corporate law, directors must act in the best interests of the company (duty of care and loyalty), which may hinder the enforcement of the SHA if its terms would conflict with such duties.

A SHA is only enforceable against its parties. There is a debate in Swiss legal doctrine as to what extent the company itself may be party to a SHA and be bound by its terms. While a majority acknowledges that the company may fulfil some administrative duties, entering into further obligations is questionable.

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Non-compete obligations of the shareholders in favour of the company are typically enforceable if the respective shareholders are (jointly) controlling the company. Furthermore, non-compete obligations need to be limited to the geographical scope and scope of activity of the company.

To secure share transfer provisions of the SHA, the parties often deposit their shares with an escrow agent under a separate share escrow agreement. Sometimes, SHAs also provide for penalty payments in case of breach.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

On a practical note, at least (i) one person with individual signatory power residing in Switzerland, or (ii) two individuals with joint signatory power both residing in Switzerland must be able to fully represent the company (entry into the commercial register). It is not necessary that such persons are board members (but, e.g. managers). Additional individual or collective signatory rights may also be granted for persons residing outside Switzerland.

Directors, officers and managers of the company (including nominees of the private equity investor) have a duty of care and loyalty towards the company and must safeguard the (sole) interest of the portfolio company even if such interest is contrary to the interest of the appointing private investor. Under special, limited circumstances, a private equity investor or an individual acting for it may be regarded as a *de facto*/shadow director of the company and, consequently, also be bound by such duties. To prevent such a scenario, decisions should solely be taken by the competent bodies.

Further, directors, officers and managers may be held liable in case of non-payment of certain social security contributions and taxes by the company.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

In case of a conflict of interest, the concerned director must inform the other board members and abstain from participating in the respective discussion and decision-making process. In typical Swiss private equity set-ups with one or few financial sponsor(s) that are each represented on the board, issues related to conflicts of interest are of limited relevance in practice.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

If certain turnover thresholds are met, a Swiss merger filing must be made. Unless the Competition Commission (CC) decides to initiate a four-month phase II investigation, clearance is granted within one month (phase I) after filing the complete application. It is strongly recommended that a draft filing be submitted for review by the Secretariat (which usually takes one to two weeks) to make sure that the filing is complete (thereby triggering the one-month period) and not rejected as incomplete 10 days after filing.

For transactions regarding certain industries, governmental approvals must be obtained (e.g. banks, telecoms, etc.). The impact on the timetable depends on the respective regulation and on the authorities involved.

Other than that, practical timing constraints such as setting up a NewCo (ca. 10 days) are similar to other European jurisdictions.

4.2 Have there been any discernible trends in transaction terms over recent years?

Since debt financing is currently easily available, buyers have become more willing to enter into binding purchase agreements prior to securing financing.

Further, given the ongoing sellers' market, share purchase agreements tend to be more seller-friendly (e.g. with regards to R&W, etc.), albeit not as extreme as in the recent past.

As a general observation, typical Swiss share/asset purchase agreements still tend to be significantly shorter in length than US/UK agreements – a consequence of Switzerland's civil law system.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Anyone who acquires equity securities which, added to equity securities already owned, exceed the threshold of one-third of the voting rights of a Swiss listed company, is obliged to make an offer for all listed equity securities of the company (mandatory tender offer), barring exemptions granted by the Swiss Takeover Board. The target company may, however, have either increased the threshold to a maximum of 49% of the voting rights (opting-up) or completely excluded the obligation to make an offer (opting-out).

Further, anyone who exceeds certain thresholds of the voting rights in a Swiss listed company (the lowest threshold is 3%) is obliged to make a notification to the company and the stock exchange (disclosure obligation).

Moreover, to carry out a statutory squeeze-out or a squeeze-out merger subsequent to a public tender offer, the bidder must hold at least 98% (for a statutory squeeze-out) or 90% (for a squeeze-out merger) respectively of the voting rights of the target company. Voluntary tender offers are regularly made subject to a minimum acceptance condition which, however, does normally not exceed two-thirds of the target company's shares (depending on the circumstances, the Takeover Board may grant exemptions). Thus, the bidder can typically not structure the offer in a way to exclude the risk of ending up holding less than 90% and, consequently, not being able to squeeze-out the remaining minority shareholders. In practice, however, bidders reach squeeze-out levels in most Swiss public acquisitions.

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5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

Both takeover parties can agree on break fees unless the fee payable by the target company will result in coercing shareholders to accept the offer or deter third parties from submitting an offer. As a rough rule of thumb, break fees should not considerably exceed the costs in connection with the offer. The parties must also disclose such agreements in the offer documents.

In addition, block trades secure an improved starting position and decrease the likelihood of a competing bid. An alternative would be tender obligations from major shareholders. These would, however, not be binding in the event of a competing offer.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

The locked-box mechanism (with anti-leakage protection) preferred on the sell-side, and NWC/Net Debt adjustments, based on closing accounts, preferred on the buy-side, are equally common in Switzerland. However, the seller-friendly market in recent years has led to an increase in the use of the locked-box mechanism. Earn-outs and vendor loans are seen less often.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

Usually, a customary set of representations and warranties is granted which is not materially different from what strategic sellers offer. Quite often, tax indemnities are seen.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Typically, the parties agree on non-compete and non-solicitation obligations for a period of one to three years.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

In the past, W&I insurances were relatively seldom used. However, with insurers being more active and given the current sellers' market, W&I insurances have become more common in Switzerland in recent years.

Generally, a W&I insurance policy will usually not cover (i) liabilities arising from known facts, matters identified in the due diligence (DD) or information otherwise disclosed by the seller, (ii) forward-looking warranties, (iii) certain tax matters, e.g. transfer pricing and secondary tax liabilities, (iv) pension underfunding, (v) civil or criminal fines or penalties where insurance cover may not legally be provided, (vi) post-completion price adjustments and non-leakage covenants in locked-box deals, (vii) certain categories of warranties, e.g. environmental warranties or product liability, and (viii) liabilities arising as a result of fraud, corruption or bribery.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

The liability for breaches of R&W is typically subject to a *de minimis* amount (depending on deal size) and a threshold amount (often approximately 1% in mid-cap transactions), as well as a cap in the range of 10–30%. Title and tax representations are often not subject to such limitations.

Managers are only liable in proportion to their shareholding.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Escrows to secure R&W are not uncommon; in particular in case of multiple sellers (e.g. when a large number of managers are co-sellers).

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Typically, in relation to the equity portion the private equity fund provides an equity commitment letter which may be enforced by the seller (obliging the private equity fund to provide the NewCo with the necessary funds). The debt portion is usually comforted by binding financing term sheets, interim loan agreements or similar. In the context of public transactions, the availability of funds must be confirmed by the review body before the launch of the offering.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are relatively rarely seen in private equity transactions; sellers often insist on actual financing proof (see above).

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

A private equity seller should be aware of the following features and challenges for a company going public:

- Lock-up: Typically, existing shareholders holding more than 3% of the share capital prior to the offering, as well as the members of the board of directors and the executive management, will be required by the underwriters to sign lock-up undertakings during six to 18 months after the IPO. Therefore, SHAs among private equity investors and agreements with directors and managers should provide for respective undertakings.

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- Drag-along rights: SHAs should also include drag rights to ensure that that there are sufficient shares to be sold in the secondary tranche.
- Corporate governance: Private-equity owned companies will have to adapt their corporate governance regimes in order to make the company fit for an IPO (including amendments to the articles of association, board composition, internal regulations, executive compensation, etc.).
- Regulation: As in most jurisdictions, Swiss law and the listing rules of the SIX Swiss Exchange provide for additional obligations of a public company (e.g. obligations regarding financial reporting, compensation of the board of directors and the senior management, *ad hoc* announcements, disclosure of major shareholdings). These obligations require additional resources within the company and the support of an external specialist.
- Liability: The liability regime and exposure in connection with an IPO is different to a trade sale. While in a trade sale, the liability of the seller(s) is primarily contractual (i.e. under the SPA) and, therefore, subject to negotiation, the main liability risk in an IPO results from the statutory prospectus liability. However, since the company going public is primarily responsible for preparing the prospectus, the sellers' exposure under this statutory regime is limited in most cases. In addition, the underwriters typically require the selling shareholder(s) to also make some limited representations in the underwriting agreement and it is advisable that these are agreed on early in the process.
- Full exit: A full exit at the listing, i.e. a sale of all shares held by the private equity seller, is typically not possible via an IPO. Therefore, the private equity seller will need to sell the remaining shares gradually or in one or more block trades after the lock-up expired.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

Typically, existing shareholders holding more than 3% of the share capital prior to the offering, as well as the members of the board of directors and the executive management, will be required by the underwriters to sign up for lock-up undertakings during six to 18 months after the IPO. Therefore, SHAs among private equity investors and agreements with directors and managers should provide for respective undertakings.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

This is heavily dependent on the general market conditions. If an IPO is considered, dual-track processes are often seen. However, if an IPO is not the preferred route at the beginning, often just a trade sale (auction) process takes place. Dual-track processes are being pursued until very late in the process, although parties try to make their final decision before the intention to float is published. Preferably, the timelines for both tracks are aligned so that the analyst reports and investor feedback on the IPO track are available simultaneously with the binding offers on the trade sale track. This allows the decision on the track to be made once there is a relative clear view on the valuation.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Private equity investors usually provide financing in the form of subordinated loans. In the context of leveraged buyouts, investors will typically use senior and junior debt in the form of credit facilities provided by financial institutions and high-yield bonds, although there are some restrictions in connection with bond financing into Switzerland. In the context of acquisitions, debt providers usually require that existing debt is refinanced at the level of the acquisition debt providers. Security released in connection with the refinancing typically serves as collateral for the new acquisition financing. The ability of Swiss target group companies to provide collateral is limited under Swiss law. Upstream security may only be granted if certain prerequisites are met, and only in the amount of the relevant Swiss company's freely distributable reserves.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

Under Swiss law, there are no statutory corporate minimum leverage requirements. However, *de facto* limitations result from the thin capitalisation rules applied by Swiss tax authorities. Interest paid on amounts of debt exceeding certain thresholds may be requalified as a hidden dividend if paid to a shareholder or a related party of a shareholder. Consequently, such interest would not be tax-deductible and subject to 35% withholding tax.

The same generally applies if debt is provided by a third party but secured by a shareholder. Furthermore, there are restrictions on Swiss companies granting loans or providing security which are of an upstream or cross-stream nature (see question 8.1 above). The Swiss tax authorities publish maximum safe haven interest rates for intercompany loans on an annual basis. Higher interest rates can be justified with a third-party test.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

The Swiss debt financing market still proves to be robust with no apparent slow-down of M&A activity and sustained negative interest rates introduced by the Swiss National Bank. Covenant-lite and loose loans (especially with respect to financial covenants) become more and more common.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Switzerland is not known as a very attractive location for the establishment of private equity funds, mainly due to the Swiss

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withholding tax and securities transfer tax regimes. Therefore, private equity funds are often established in jurisdictions like Jersey, Cayman Islands, Luxembourg, Scotland or Guernsey.

Private equity acquisitions in Switzerland are mainly performed by NewCo acquisition vehicles (holding company) from jurisdictions with which Switzerland has concluded a double taxation treaty and which foresee a 0% Swiss withholding tax for a qualifying (minimum 10% shareholding) dividend distribution from a Swiss company.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

There are no specific tax reliefs or tax provisions for management share participations, except for blocking period discounts (6% per blocking year) if shares are acquired below fair market value.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

Swiss-resident managers generally try to achieve a tax-exempt capital gain upon the sale of privately held shares. In order not to qualify as salary (like synthetic bonus schemes), the managers should have full ownership rights (dividend, liquidation, voting rights). A tax neutral roll-over may be structured in certain circumstances. Whether the sale of shares under a management participation qualifies as a tax-exempt capital gain is a case-by-case decision since preferential terms (like sweet equity) or a later investment at a formula value could lead to (partial) taxable salary for the managers upon sale and social security charges for the Swiss employer. Thus, it is recommendable to confirm the consequences of a specific management participation in an advance ruling.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

The substance of foreign acquisition companies and their qualification as beneficial owners of the shares in the Swiss target in order to benefit from a Swiss dividend withholding tax reduction are recently subject to more scrutiny by the Swiss Federal Tax Administration. Thus, a diligent set-up and advance tax ruling confirmation are recommended, in particular since a future buyer will generally inherit the current withholding tax situation under the so-called “old reserve” regime and address such withholding tax risks in the purchase price determination. Under the OECD’s multilateral instrument, Switzerland has opted to apply a principal purpose test, which should generally not change the currently applied practice.

The OECD base erosion and profit shifting (BEPS) standards were implemented by Switzerland, e.g. country-by-country reporting, spontaneous exchange of tax rulings, with entry into force as of 2017 (with tax ruling exchange to be made as from 1 January 2018) and as of 2018 (country-by-country reporting) respectively, in Switzerland.

Further, the anticipated corporate tax reform, under which privileged tax regimes will be abolished (entry into effect expected as of 1 January 2020, subject to the public vote in May 2019), will have an impact on the effective tax rates of Swiss target companies, since general reductions of tax rates and measures like patent boxes are expected to be introduced to maintain the attractiveness.

Tax authorities tend to scrutinise tax-exempt capital gains for selling individuals; thus, earn-out arrangements for sellers continuing to work for the target or non-compete agreements may partly qualify as taxable income for the seller and should be structured carefully. It is important to note also that payments by related parties could qualify as (taxable) salary which is generally subject to social security contributions by the Swiss employer.

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

After a major revision of the Swiss collective investment schemes legislation in 2013, private equity funds may qualify as collective investment schemes under Swiss law (Collective Investment Schemes Act, CISA). Under the CISA, the requirements for the offering and placement of funds mainly depend on whether the fund interests are being “distributed” in the meaning of CISA in or from Switzerland and, if so, whether they are distributed to qualified investors only or to other persons as well. As a result, the concept of distribution is key to determining the admissibility of offering interests in private equity funds in or from Switzerland. This new concept replaced the previous distinction between public distribution and private placement under the old CISA.

As a consequence, fundraising has become more complex. In particular, special attention has to be paid to the question of what kind of investors can be approached for fundraising. In short, interests in private equity funds may still be freely offered to regulated financial intermediaries such as banks, securities dealers, fund management companies and insurance companies in Switzerland (the so-called “super-qualified investors”). Fundraising from these super-qualified investors does not qualify as “distribution” and is, therefore, not subject to the distribution rules of the CISA. The case is different for the offering of interests in private equity funds to qualified investors, as this may be subject to legal and regulatory requirements (e.g. the requirement for a Swiss paying agent and representative of the funds). Distributors of foreign funds to Swiss qualified investors need to be adequately supervised, with Swiss distributors requiring a licence from the Swiss Financial Market Supervisory Authority (FINMA).

One of the more recent regulatory developments has been the enactment of the Financial Market Infrastructure Act (FinMIA) on 1 January 2016, which provides for improvements in the provision of financial services and financial instruments in Switzerland, and has been drafted in conformity with the respective European provisions and international standards. It contains rules regarding the financial markets infrastructure and the trade in derivatives, such as provisions for operators of an organised trading system regarding organisation and transparency of trade. Furthermore, the FinMIA contains a set of “market rules of conduct”, which regulate the financial market participants’ activities in relation to securities and derivatives trading. These include the provisions on the disclosure of shareholdings, public takeover offers, insider trading and market manipulation that were formerly included in the Stock Exchange Act, as well as the new regulations for derivatives trading, which are in line with international standards.

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The next major regulatory development in the area of financial markets will be the enactment of the Financial Services Act and the Financial Institutions Act (FinSA and FinIA), which will enter into force in 2020. These will change the regulatory landscape for financial services significantly, with the FinSA being to some extent modelled on MiFID. In particular, the new laws will affect the distribution regime under the CISA. For one, the distributor licence requirement will be eliminated in favour of registration and other regulatory requirements applicable to client advisers. Furthermore, the concept of "distribution" will be replaced by a more narrowly defined concept of "offering", and changes to the available exemptions and the categories of qualified investors will be introduced. The new regime is expected to substantially decrease the compliance burden for offering foreign collective investment schemes to Swiss qualified investors. In particular, it will be possible to offer foreign collective investment schemes to all types of qualified investors (except high-net worth individuals) – not only "super-qualified investors" – without triggering a requirement to appoint a Swiss paying agent and representative.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

While a few voices in politics have called for scrutiny on foreign investments in the recent past, there are no political majorities at this point for stricter laws in that respect.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

The legal DD usually covers the following areas: corporate; financing agreements; business agreements; employment; real property/lease; and IP/IT and litigation. The handling of compliance and regulatory matters depends on the specific case. Typically, an external legal counsel is engaged to conduct a red flag legal DD of two to four weeks' duration.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

In DD, a focus on compliance of target companies with anti-bribery, anti-corruption and economic sanctions has increased in recent years.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Under special, limited circumstances, a private equity investor or an individual acting for it may be regarded as a *de facto*/shadow director of the company and, consequently, be bound by directors' duties (see question 3.6).

A private equity investor that (solely or jointly) controls a portfolio company that has infringed competition law could be made jointly and severally liable for paying the resulting fine. While it is possible that a portfolio company may be made liable for the liabilities of another portfolio company, this is a less likely scenario. See also section 11 below.

Under normal circumstances it is highly unlikely that a portfolio company will be liable for another portfolio company.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

In April 2014, the European Commission imposed a €37 million fine on Goldman Sachs for antitrust breaches committed by a portfolio company that was formerly owned by its private equity arm, GS Capital Partners. GS and the portfolio company were held jointly and severally liable for the fine. GS was held liable on the basis that it exercised decisive influence over the portfolio company, although GS was not alleged to have participated in, been aware of or facilitated the alleged cartel in any way. Even though in Switzerland no such precedents in relation to private equity companies exist so far, it is possible that the Swiss Competition Commission could follow the European Commission's line of thinking. In Switzerland, holding companies tend to be found to be jointly and severally liable for the antitrust fines of their subsidiaries. Private equity investors should, therefore, implement a robust compliance programme in their portfolio companies to avoid antitrust law infringements.

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Chambers Global and *Europe* rank him as a leader in the field of M&A (since 2010) and *IFLR1000* lists him as one of the leading lawyers in Switzerland (since 2012). The *International Who's Who* of M&A Lawyers lists Christoph Neeracher as one of the world's leading M&A lawyers. *The Legal 500* (2012) describes him as "extremely experienced in M&A matters and very strong in negotiations" and ranks him among the leading individuals. Christoph Neeracher is ranked first in *Mergermarket*'s Profile League Table for 2016's most prolific individual DACH legal advisors.

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Luca Jagmetti has several speaking engagements on asset transactions, legal DD and other M&A topics (e.g.: Akademie der Treuhand-Kammer; the Seminar on Mergers & Acquisitions for practitioners; and the Course on Commercial Law of the University of St. Gallen).

According to *The Legal 500* 2016 he is "very knowledgeable and speedy". *IFLR* 2018 lists him as a noticeable practitioner. Luca Jagmetti is jointly ranked first in *Mergermarket*'s Profile League Table for 2016's most prolific individual DACH legal advisors.

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2019 *International Financial Law Review* (*IFLR)* "Debt and Equity-linked Deal of the Year" Award.

2019, 2015 and 2014 *IFLR* Awards.

2018 *IFLR* "Deal of the Year" Award.

2018, 2017 and 2016 Trophées du Droit Gold or Silver.

2018, 2016, 2015 and 2014 *Mergermarket* M&A Awards.

2016, 2013 and 2012 *Chambers* European Awards.

2016, 2015 and 2014 *The Legal 500* ("most recommended law firm in Switzerland").

2015, 2014, 2013, 2011 and 2010 *The Lawyer*'s European Awards.

2015 Citywealth Magic Circle Awards ("International Law Firm of the Year EMEA").

2014 Citywealth International Financial Centre Awards.

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

The most common types of private equity ("PE") transactions in the UK centre around leveraged buyouts (in the form of share and asset acquisitions), take private transactions, refinancings, flotations and bolt on transactions.

Based on the British Venture Capital Association ("BVCA"), the value of PE investments in the UK since 2016 has consistently remained between £21.5 and £22.5 billion. While this has proved to be a strong and consistent deal flow in the UK in the past few years, buyout activity in 2018 was dampened, especially on a value basis driven by a lack of large deals. There were a number of large exits in the UK in 2018 with sponsors appearing to crystallise returns ahead of Brexit.

Numerous considerations for PE remain with the backdrop of Brexit. The UK is due to withdraw from the European Union on 31 October 2019, although at the time of writing the terms under which the country will leave are unclear.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

The UK has historically been the largest PE market in Europe and has a long and proud history in welcoming PE sponsors to fundraise and invest there. As such, the UK has a well-established legal system and regulatory footprint to deal with various outcomes and challenges which the PE industry may face from time to time. The experience which the PE industry gleaned in the UK in the aftermath of the financial crisis in 2008 has delivered a strong and robust system and created new asset classes and credit funds which have adapted to the leveraged buyout system.

There has, however, been a pronounced fall in the UK's standing in recent times, primarily brought about by Brexit. Country-focused funds that invest exclusively in the UK may find fundraising challenging as international LPs adopt a "wait and see" approach and then there is the impact on portfolio companies to consider. The potential introduction of trade tariffs will be onerous for portfolio companies with highly regulated industries such as pharmaceutical companies and companies which rely heavily on imports and exports will likely be most exposed.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

The PE industry will continue to adapt and drive value creation through their portfolio companies in highly focused and more innovative ways. This will be handled through conventional add-on acquisitions but also platform deals where PE sponsors rebrand an asset from the outset with a new management team. This is most likely to be achieved through carve-outs of entities from large corporates.

We also expect to see more exits in the UK as PE investors are keen to lock in returns ahead of the country's expected withdrawal from the EU on 31 October 2019. Given the uncertainty around the UK's departure date it makes sense for funds to want to crystallise returns ahead of the departure date.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

PE transactions in the UK are typically structured using a UK private limited company limited by shares ("Topco"), commonly owned by the PE fund and management executives, which act as the holding company for a chain of corporate entities. The bottom entity in the acquisition chain, "Bidco", acts as the buyer of the target shares and may act as borrower under any financing arrangements. A series of entities are typically incorporated between Topco and Bidco for tax and financing purposes, so as to allow for financing by junior lenders to be structurally subordinated to that by senior lenders.

Where transactions involve a UK target, Bidco would typically be a UK-resident limited company. However, Topco (the level at which a future sale by the PE fund of the UK acquisition usually takes place) may be a non-UK incorporated but UK-resident company as a means of mitigating UK stamp duty, which is payable (usually) by a buyer at 0.5% on the future transfer or sale of shares in a UK company. It remains to be seen if increased substance requirements in typical offshore jurisdictions (such as the Cayman Islands, Bermuda, Jersey, etc.) will impact upon such UK stamp duty planning.

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2.2 What are the main drivers for these acquisition structures?

Structures are typically driven by a number of factors, including: (i) the tax and other requirements of the private equity funds investing in the transaction; (ii) the requirements of the lenders financing the transactions (for example as to any required subordination); (iii) the overall tax-efficiency of the post-acquisition group (for example as to achieving the maximum deductibility of interest expense); and (iv) the requirements of management (for example, if they are seeking to qualify for entrepreneurs' relief).

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

PE investors will typically subscribe for ordinary shares in Topco. However, the ordinary shares subscribed by the private equity investor typically represent only a small proportion of its funding of the transaction. The majority of the PE investor's commitment is typically funded as shareholder debt, usually in the form of "payment in kind" ("PIK") loan notes, which carry a right to annual interest which the issuer ("Topco") may choose to satisfy by the issue of further loan notes. Preference shares may be used where the shareholder debt would otherwise exceed the levels permitted by transfer pricing rules or corporate interest restriction rules. The combination of ordinary share capital, preference shares, and shareholder debt held by the PE investor is commonly referred to as the "institutional strip".

Management will commonly also take an equity piece in Topco in order to ensure their interests are aligned with the PE investors. This is often referred to as "sweet equity" or "sweat equity". In some cases, in particular on a secondary buyout where they may be required to reinvest realised gains, senior executives may invest in both the institutional strip and the sweet equity. Management equity incentive plans will often be put in place to further incentivise management and other employees.

Carried interest (a performance-related share of the fund's overall profits) is typically structured through a limited partnership, with executives as limited partners. Often the carried interest limited partnership will itself be a special limited partner in the fund limited partnership to allow carried interest to flow through the structure on a transparent basis such that executives can benefit from capital gains tax treatment on a future exit. Entitlement to carry is typically crystallised after investors have received a return of their drawn-down capital, plus any preferred return accrued and after any other pre-agreed hurdles are achieved. As noted in section 9, recent changes to the UK tax treatment of carried interest need to be considered.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

The drivers described in question 2.2 will remain relevant but the minority position taken by a private equity investor may limit the ability of the investor to dictate the relative importance of these factors.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Management would typically hold between 5% and 15% of the equity, although this will be very transaction-specific and the proportion may be lower in larger transactions.

Transaction documents will invariably include a right for the PE investor to acquire a manager's equity following the termination of his/her employment with the relevant portfolio company. The terms of such compulsory acquisition will usually depend on whether the manager is a good leaver or a bad leaver.

Good leavers will commonly be entitled to receive the higher of costs and, subject to vesting provisions, fair market value for their shares. A "bad leaver" would commonly be entitled to the lower of fair market value and cost. Vesting provisions will often determine the proportion of a good leaver's shares which will qualify for good leaver treatment. This will generally be based on the expiry of a specified vesting period (usually three to five years) following the transaction to the termination of employment. Vesting may take place on a *pro rata* "straight-line" basis over the vesting period or on a "cliff-edge" basis only on closing of the vesting period.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Good leavers are typically those who cease to be employed by reason of their death or disability, retirement (although care should be taken with regard to potential discrimination under UK employment law) or involuntary termination without cause (for example, redundancy). There may be a discretion for management not falling within such categories to be treated as good leavers nonetheless. Typically, a leaver who is not a good leaver is a bad leaver.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

The primary contractual document controlling the governance of a PE portfolio company in the UK is generally a shareholders' agreement, setting out the arrangements agreed by the PE Sponsor, management, and any other shareholders in the company. The typical matters that this agreement will cover extend to day-to-day management appointments and behaviour, conduct of business of the company (generally expressed through the form of vetos for the PE sponsor), positive covenants for management to follow in their operation of the business, control of share transfers, information rights for the PE sponsor and controls over the raising of further equity and share capital for the company. This governance arrangement may be supported by the presence of a PE sponsor-appointed director or observer on the board of the portfolio company. The shareholders' agreement is a private contract agreed between the shareholders of the portfolio and does not generally need to be filed.

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Additionally, the primary constitutional document of an English company is its articles of association. Certain governance controls tend to be included in the articles by the PE sponsor (as a breach of these provisions then becomes an *ultra vires* act of the company, as opposed to merely a contractual breach), particularly in relation to transfer rights. Articles of association are a publicly filed document, so PE sponsors should be mindful of this in terms of the information included.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Yes. These veto rights tend to be expressed via a director's veto (in circumstances where the PE Sponsor has a director appointed to the board) and/or a shareholder veto. Inevitably, there is a balance which needs to be struck (in circumstances where PE controls the majority of the investee company) between the need for the PE Sponsor to protect and manage its investment, drive an exit, and control strategic issues, and the ability of management to manage the portfolio company day-to-day.

Where PE has a minority position, the veto rights tend to be focused on protection of economic interests, and only fundamental strategic matters, i.e. anti-dilution, share transfers, exit below an agreed valuation, and fundamental change of business.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

At a shareholder level, veto rights are generally respected but can run into issues if they fall foul of certain English law rules aimed at promoting proper corporate behaviour, primarily (a) preventing actions which may unfairly prejudice a minority shareholder(s) of the company, (b) not allowing any inappropriate fettering of any statutory powers of the company, or (c) preventing actions being taken which are contrary to UK public policy.

At the level of a director nominee, the same issues can arise as outlined above. Additionally, the relevant director will, by virtue of his or her directorship, also owe a wide range of duties to the company, its shareholders (i.e. not just the appointing PE shareholder) and, if a company nears insolvency, its creditors. These duties override and can impede the exercise of certain vetos.

Vetos which are contrary to law can be challenged and may not be upheld. To ensure that a director's veto is properly implemented as between the company's shareholders, it will typically be contained in a shareholders' agreement and/or the company's articles and so (subject to the points above) can be implemented effectively among the company's shareholders.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

A PE sponsor shareholder does not *prima facie* owe duties to other shareholders in the company. As explained in the answer to question 3.3 above, however, a director appointee of a PE sponsor is subject to fiduciary and statutory duties to the wider company and, in certain cases its shareholders. Successful actions brought against PE-appointed directors on behalf of the company (a derivative action), or by aggrieved shareholders on the basis of unfair prejudice are rarely brought, and even more rarely successful, but are available in theory.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

English law shareholders' agreements relating to an English company are generally effective and respected under English law (which is generally accepted as governing law and the jurisdiction for resolving disputes), provided that they are properly drafted. That said, provisions in shareholders' agreements which purport to offend the principles outlined in the answer to question 3.3 above around proper corporate behaviour can be problematic to enforce. In addition, certain European legislation, for instance the European General Data Protection Regulation ("GDPR") which governs the transmission and collection of data in Europe can, for as long as the UK remains in the European Union, add further challenges to older shareholders' agreements which may find their existing provisions (e.g. in relation to information) ceasing to be compliant with new regulations.

Non-compete and non-solicit provisions need to be aimed at providing reasonable protection for the relevant goodwill (i.e. the investment of the PE sponsor in the company), for a reasonable period, and within a reasonable area in order to be effective under English law. As a basic position, English law dislikes covenants which attempt to unfairly restrain trade or prevent an individual from working to support him or herself, so such covenants will need to be carefully drafted in this context, in order to be effective.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

PE investors must ensure that nominee directors are eligible to act as directors including, in particular, that they are not disqualified from acting as a director, for instance under the UK Company Directors Disqualification Act 1986. As outlined above (particularly in the answer to question 3.3), directors of an English company (whether considered "executive" or "non-executive", and irrespective of their appointing shareholder(s)) share the same broad general fiduciary and statutory duties to the company of which they are a director. This can create personal risk and liability for the director concerned, if the director acts only in the best interests of his or her appointer. Although a PE sponsor will not incur direct liability for the actions of its appointed director, it could have indirect issues caused, including (a) failure of the appointed director to act as they expect or would prefer (e.g. where the relevant director is subject to statutory duties requiring certain behaviour (e.g. to place a company into insolvency proceedings where it is insolvent)), and (b) consequential issues *vis-à-vis* their investors due to their failure to procure that their investee company acts as they would prefer.

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3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

As explained in the answer to question 3.6 above, directors appointed by PE sponsors do not only owe duties to the sponsor, but to the companies of which they are directors more generally.

The Companies Act 2006 imposes a duty on a director to avoid a "situational conflict", i.e. a situation in which he or she has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. Clearly, a "situational conflict" could occur where the appointed director also has a directorship with companies with interests adverse to those of another company to which he or she has been appointed as a director. It should however be noted that a "situational conflict" can be authorised by the non-conflicted directors of the relevant company(ies), and so such authorisations should be obtained where relevant.

Additionally, directors may find themselves in a position of actual conflict in relation to existing or proposed transactions or arrangements of companies they are appointed to. This is generally known as a "transactional conflict". Directors are generally required to declare their interests in such transactions or arrangements. Having made such a disclosure, the ability for a director to participate in the decision-making process with regard to such transactions will be governed by the articles of association of the relevant company. It is not uncommon, once such interests have been declared, for a director to remain capable under the articles of participating in the relevant decisions. A director will not be in breach of duties in relation to conflicts to declare an interest in a proposed transaction if he or she acts in accordance with any provisions of the company's articles dealing with conflicts.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

UK transaction closing timetables are largely driven by regulatory approvals, most commonly mandatory and suspensory antitrust filings and industry specific regulatory approvals or consents. There has been a reduction in financing conditionality, particularly given the prevalence of sales by way of competitive auction processes where sellers are able to push bidders to obtain financing on a "certain funds" basis at the binding bid stage. The prevalence of auction processes has also led to a general increase in the speed at which PE transactions are executed, with a rising number of auction processes being pre-empted by one bidder

4.2 Have there been any discernible trends in transaction terms over recent years?

The UK PE M&A landscape continues to be generally favourable to sellers (both PE and non-PE). Recent trends include: (i) an increase in the number of sale processes being run as competitive auctions on a tight timetable; (ii) increased prevalence of pre-emptive bids in competitive processes; (iii) further growth in the use of warranty and indemnity ("W&I") insurance, often with low residual seller liability; and (iv) shorter seller liability time periods, in many cases regardless of whether W&I insurance is being used. However, as with all trends, there are notable exceptions and PE buyers are well placed to negotiate positions more advantageous than these industry norms, particularly by making use of speed, commerciality and other unique advantages.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Acquisitions of the shares of public companies in the UK are generally governed by the UK City Code on Takeovers and Mergers (the "Takeover Code"). The Takeover Code imposes various rules on the conduct of such activity, generally aimed at ensuring equality of information and treatment for all of the shareholders of the target public company, including its minority shareholders. This framework is substantially more restrictive than the framework applicable to private transactions.

Provisions of the Takeover Code that are likely to be particularly relevant to PE sponsors undertaking public to private deals are: (i) specific timetables applicable to such deals; (ii) a need to announce whether or not an offer will be made for a public company within a 28-day period if the likelihood of an offer being made becomes publicly known; (iii) restrictions on the payment of break fees by public company targets on deals; and (iv) the Takeover Panel's (the entity which governs the application of the Takeover Code) increasing focus on a bidder's intentions regarding the target's business following acquisition, and the need for any plans for closures and lay-offs to be disclosed when a bidder announces its firm intention to make an offer. One year after the closing of an acquisition, a bidder must confirm to the Takeover Panel whether or not it has taken the intended course of action and publish that confirmation. Inevitable reputational consequences can follow from a failure to owner specific communicated post-offer intentions.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

Only somewhat limited protections are available. Normal measures used on private deals, such as break fees, are generally prohibited under the Takeover Code, because of concerns that such protection mechanisms deter potential bidders from submitting competing bids, therefore maximising value for shareholders in publicly-listed companies. That said, the Takeover Panel may allow break fees in very limited circumstances. This can include where the target is in financial distress and seeking a bidder, or in certain hostile situations. Such break fees are then typically limited to a 1% cap of the target's value.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

"Locked-box" consideration structures remain the preferred option

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for PE sellers largely due to the ease of negotiation and the certainty they provide with respect to the final consideration paid. Combined with the shorter leakage periods being obtained by PE sellers (some as low as three months post-closing) they present a highly attractive proposal when compared to a traditional completion accounts consideration structure. An additional benefit of a "locked-box" deal is that because there is no post-closing adjustment, funds can be distributed immediately following closing, allowing a PE seller to optimise investor/LP returns.

Given that the current market is a seller's market, "locked-box" consideration structures are commonly accepted by buyers except in limited circumstances, including where a the target is a carve-out of a larger business and separate accounts are not maintained, where there have been historical issues with accounts or audits or where some other aspect of the target or the seller profile makes the deal unsuitable for a "locked-box" consideration structure. A "locked-box" consideration structure when compared to a completion accounts consideration structure will generally be seen as shifting risk from the seller to the buyer, as the buyer (together with their advisors) will need to fully diligence the relevant "locked-box accounts" and ensure they are comfortable doing the deal on the basis of those accounts.

Where a completion accounts consideration structure is used, it is common to see a portion of the purchase price placed into escrow with a third-party escrow agent at closing as security for any post-closing payment which is required to be made by the seller as a result of the completion accounts adjustment.

Where an acquisition is made by a PE buyer in a "primary" deal (i.e. not from a PE seller), it is not unusual for a portion of the consideration to paid on a deferred basis, most commonly pursuant to an "earn-out" where the performance or growth of the acquired business will be measured against an objective criteria (usually a financial-based criteria during a defined time period) in order to determine what portion of the deferred consideration will be payable.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

A PE seller will in most cases only provide "fundamental" warranties, being those regarding title to shares, capacity and authority. A PE seller will only provide business and operational warranties as to the target in limited circumstances and this is becoming rarer under the current market conditions.

Business and operational warranties are usually given by certain members of the senior management team of the target and will be given subject to relatively low liability caps (dependent on the deal proceeds received by management warrantors). These business and operational warranties will be contained in a separate management warranty deed and a fulsome disclosure process will be carried out to disclose against these warranties. These management warranties are more and more being seen as a tool to elicit accurate and fulsome disclosures regarding the target from the individuals who run the business of the target on a day-to-day basis. Given the low liability caps that generally apply to these warranties from management, a buyer will typically seek to obtain coverage for these warranties above the liability cap of the management warrantors by putting in place W&I insurance.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

PE sellers will customarily provide certain pre-closing covenants and undertakings to a buyer, including: (i) a no-leakage covenant (in the case of a "locked box" deal) where the buyer will be able to recover any leakage on a £-for-£ basis; (ii) covenants to provide assistance with, and if relevant, obtain regulatory clearances or satisfaction of other conditions; (iii) operational covenants as to how the business of the target may or may not be run in the pre-closing period; and (iv) certain limited covenants regarding the provision of information during the pre-closing period. Indemnification for specific risks is relatively uncommon for PE sellers to give, although it is sometimes seen where the PE seller and the buyer have a materially different view on the likelihood of a specific risk crystallising. More commonly, PE sellers are pushing buyers to "price in" these types of risks.

PE sellers are unlikely to give non-compete covenants, whereas it is common for exiting members of management or founders to give a full suite of restrictive covenants.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

W&I insurance as a product is continuing to increase in popularity with buyers and sellers seeing the benefit of the product in "bridging the divide" between sellers (including management warrantors where relevant) and buyers in terms of residual post-closing liability. It is relatively standard in a competitive sell-side process for the seller to insist on use of W&I insurance by the buyer to cover the business and operational warranties which are provided by management. In some transactions, more aggressive sellers will also insist that the buyer obtains coverage for the fundamental warranties as to title to shares, capacity and authority up to the W&I insurance policy liability cap with the seller standing behind the balance of liability above the W&I insurance policy liability cap for the fundamental warranties.

Excesses and policy limitations and resulting pricing will differ based upon, and be impacted by, insurer, industry sector, quality of diligence, thoroughness of disclosure process and seller/management warrantor liability cap. With respect to business and operational warranties, the usual buyer recourse profile will be first against the seller/management warrantor up to the relevant excess (which will usually match the attachment point under the W&I insurance policy) and then against the W&I policy up to the relevant liability cap of the policy. The *de minimis* financial limitation that applies to claims under the business and operational warranties will commonly match in the transaction documentation and the W&I policy and is often driven by the W&I insurer. It is unusual for sellers/management warrantors to stand behind any additional liability above the relevant W&I policy liability cap, except where the fundamental warranties are being insured. In terms of the W&I policy liability caps being obtained in buy-side W&I policies, these range from between 5% and 100% of enterprise value, with the most common range being between 20% and 40% of the enterprise value of the target.

More recently there has been a trend towards lower seller/ management warrantor excesses (i.e. liability caps in the transaction documentation) and, in some limited cases, an excess as low as £1

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can be obtained where the business of the target is considered particularly "clean" and insurable. Where management warrantors are required to have material "skin in the game" under the management warranty deed, it is common for the relevant PE seller to offset this potential liability by way of escrow or retention to fund claims against management or by way of transaction bonuses payable on closing.

The major downside of W&I insurance is that there are certain exclusions, both general to all W&I insurance policies (i.e. secondary tax liabilities, anti-bribery and corruption) and transaction-specific to address gaps in the scope of diligence carried out or particular risks relevant to the industry in which the target operates. In the current market, sellers/management warrantors do not customarily stand behind warranty claims which fall within the ambit of such policy exclusions and instead this potential risk is borne by buyers and ultimately priced in.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Given that a PE seller's warranties will generally be limited to certain fundamental warranties as to title, capacity and authority, a PE seller's liability for these warranties is typically capped at the purchase price. Such fundamental warranties are not usually subject to additional financial limitations, such as a *de minimis* or threshold (i.e. excess). The fundamental warranties are typically given subject to time limitations of between three and seven years from closing.

Seller liability under the "no-leakage" covenant is usually uncapped and recoverable from the seller on the basis of leakage received or benefitted from, given that compliance with such a covenant is entirely within the control of the seller.

The liability of management warrantors for the business and operational warranties can be subject to various negotiated limitations, including: (i) warranties are usually given on a several basis only (i.e. each manager is only liable for its proportionate share of liability for any claim and/or its own breach); (ii) warranties can be given subject to actual awareness of the relevant management warrantor group; (iii) financial limitations as to (A) aggregate liability cap, (B) threshold, below which a warranty claim cannot be made (which can be on a "tipping" basis or "excess only" basis) and (C) *de minimis*, being the minimum quantum of liability which a warranty claim must meet in order to count towards the threshold; and (iv) time limitations within which claims under the warranties must be made which range from between one year and three years for claims under the non-tax warranties and between four and seven years for claims under the tax warranties.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Given PE sellers generally only provide fundamental warranties as to title, capacity and authority, no security (financial or otherwise) is provided as the risk of a breach of these warranties should be very low. With respect to the no-leakage covenant provided in "locked-box" deals, it is uncommon for PE sellers to provide any security in relation to this risk as most buyers take the view that the reputational damage caused to a PE seller for a large leakage claim is a material deterrent to the PE sponsor engaging in activity which constitutes leakage. This position also aligns with the PE industry focus of returning proceeds to LPs/investors as soon as possible post-closing in order to maximise economic return metrics.

This position is clearly at odds with the general desire of buyers (both PE and non-PE) to obtain meaningful post-closing recourse with respect to warranties and covenants. Given the fact the current market is largely a seller's market, this had been a major driving factor in the rise of W&I insurance.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

PE buyers will usually provide an equity underwrite of the total consideration amount to the seller in the form of an equity commitment letter from the PE fund itself. Such an equity commitment letter will generally be addressed directly to the seller and includes covenants that the fund will (i) call required capital from its investors to fund the purchase price, or (ii) fund Bidco with the equity capital required to fund the relevant portion of the purchase price, which is subject only to the satisfaction of the conditions in the share purchase agreement and "certain funds" debt financing being available. This equity commitment letter will customarily also include certain commitments from the PE sponsor aimed at ensuring Bidco draws down the requisite funds under the "certain funds" debt financing in order to complete the transaction.

The seller will usually be able to enforce this commitment directly against the PE fund to the extent the transaction becomes unconditional and the buyer fails to comply with its obligations to pay the consideration under the transaction documentation. If the banks under the "certain funds" debt financing do not fund when they are legally required to, the PE buyer may be required to take certain steps to enforce against the banks and/or use reasonable endeavours to obtain alternative debt financing. It would not be typical for a PE buyer to be required to fund such debt financing amounts from equity, i.e. it will not typically equity underwrite the debt financing.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

Reverse break fees are uncommon in the current UK private equity market largely as a result of the fact that in the UK market it is not typical for a buyer to have a walk-away right between signing and closing, e.g. in the event of a "material adverse change" in the business or if the debt financing is not obtained (as opposed to the USA, where both of these rights for buyers are more common and hence so is the use of reverse break fees).

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

Exiting from an investment by way of an IPO raises a number of issues, including (but not limited to):

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Costs: Pursuing an IPO can be considerably more costly than an exit by way of a private sale, due to the fees of the advisers involved, together with the fees of underwriting the exit. It is also likely to take longer to execute a successful IPO, perhaps up to six months, due to the various processes involved in presenting a company properly to the public markets.

Uncertainty: Exiting from an investment via an IPO can expose PE sellers to significantly greater market risk than the relative certainty of a private deal. It is not guaranteed that sufficient investor capital will be available to support an exit. In addition, any failures of an IPO are inevitably more "public" than the failure of a private disposal process. This can add wider reputational risk to a disposal.

Incomplete exit: When an IPO is successful, that still does not generally enable an immediate full exit for the PE fund on day one of the IPO. It is typical that the PE sponsor would be subject to a "lock in" period for at least six months following a successful IPO, during which time it will not be able to sell its shares in the listed company. And following the end of the "lock in" period, it is likely that an "orderly market" period (perhaps of up to twelve months) will follow, during which the sale of the PE sponsor's stake in the business can only be sold in a staggered way, to avoid affecting the price of the target company's shares too significantly as a result of the disposal.

Unclean exit: The reluctance of a PE sponsor to provide any ongoing W&I protections in relation to the sale of their target companies is well-understood. However, in relation to any IPO of a PE-invested business, the PE sponsor will find it increasingly challenging to resist providing an investment bank underwriting the IPO with at least some warranties in relation to its ownership of the shares in the company being floated, in relation to itself and, in certain circumstances, in relation to an underlying business.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

As mentioned in the answer to question 7.1 above, the duration of the "lock-in" provided by the PE sponsor will vary from transaction to transaction but typically applies for a period of at least six months following an IPO. This means that no actual "exit" (in terms of realising value from the investment) will have been effected by the PE sponsor at the closing of the IPO; but only once the lock-up period has expired. In the meantime, the PE sponsor remains exposed to market risk for the duration of the "lock-in" period and, to a lesser extent, during the orderly market disposal period.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

During 2018, successful PE exits continued. It was not uncommon to run a dual-track exit process, though a greater number of deals were concluded by way of bilateral or auction-driven private sales processes, as opposed to successful IPOs. This is reflective both of market conditions and also a general preference by funds to conclude private deals where possible, in order to avoid some of the negative aspects of a IPO exits (as outlined in the answer to question 7.1 above), provided that the valuations achieved on such deals are at an acceptable level.

In order to preserve competitive tensions in deals, it is not uncommon on dual-tracks to run such processes in parallel, at least until the commencement of an investor "road show" in relation to the IPO process. Immediately prior to the commencement of the road show is usually a reasonable inflexion point for the PE sponsor to consider whether it has an acceptable (and deliverable) private offer for the asset to be disposed; one reason for this being the level of information about the target that will be shared with potential investors in the road show process, and a desire to avoid this if a private sale seems feasible. Noting that given the private nature of many of these processes, full public information about dual-track processes and their outcomes is not available, it is safe to say that it is comparatively rare for the IPO track to be abandoned during the period after the roadshows have finished, but prior to the expected date of listing and admission of the target.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

Traditional bank-led leveraged loan financing remains the most common source of debt finance used to fund both mid-market and large PE transactions in the UK.

However, in recent years, there has been increasing competition between traditional bank lenders and non-bank (or "alternative") lenders for mid-market PE transactions, with funding increasingly being sought from alternative sources such as direct lending funds and other institutional investors. Participants in mid-market transactions have also increasingly looked to implement "unitranche" financing structures, pursuant to which traditional senior and junior debt tranches are replaced by a single tranche term facility carrying a single, blended rate of interest. Other debt instruments, such as PIK or convertible debt, remains a small portion of the overall financing provided by third-party lenders.

For larger PE transactions, leveraged loans are often structured as a term loan B (or "TLB") – a non-amortising, senior secured term loan. Investors in TLB include a mix of traditional bank lenders and institutional investors.

Aside from leveraged loan financing, high-yield bond financing remains an important source of funds and is commonly (albeit subject to fluctuating availability in the market) used alongside traditional senior secured bank loans.

A key theme in the UK leveraged finance market in recent years – and a function of the increased appetite of institutional investors (who traditionally invested in high-yield bonds) for leveraged loans – has been the convergence of the terms of English law leveraged loans with both high-yield bonds and U.S. leveraged loans. This has led to a general loosening of covenants in English law leveraged loans, with the market becoming more accepting of "covenant-loose" structures (that is, where the relevant loan agreement contains only a single on-going or maintenance financial covenant, usually a leverage ratio) and, for certain stronger borrows, "covenant-lite" structures (that is, where the loan agreement contains no maintenance financial covenants).

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

Generally speaking, the UK is an investor-friendly jurisdiction and

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there are no particular legal requirements or restrictions that would affect the choice or structure of debt financing of PE transactions in the UK. That said, practical deal concerns play an obviously important role in dictating the ultimate financing structure. For example, some PE funds have valued the lighter disclosure requirements of a leveraged bank loan as compared to a high-yield bond issuance (which requires the preparation of, amongst other things, a detailed offering memorandum). Further, in an acquisition context, another advantage of a loan (rather than a high-yield bond issuance) is that loans can typically be documented and executed on a much shorter timetable that is more aligned with the timing constraints of the acquisition itself. With its successful execution dependent on ever-fluctuating market conditions and increased disclosure requirements, a high-yield bond issuance, on the other hand, must typically either be bridged by a loan or funded into an escrow arrangement if being used to finance an acquisition.

Aside from such practical concerns, market participants should be aware of, and ensure compliance with, any industry-specific laws and regulations, as well as the broader regulatory regime affecting private equity transactions.

For example, in the current sensitive political and regulatory climate, market participants need to be especially careful in regards to compliance with anti-bribery, corruption and sanctions laws. Aside from local laws, borrowers and sponsors should also be aware of the expansive nature and potential extraterritorial reach of such laws and regulations in the U.S., which can necessitate compliance by many non-U.S. entities (or entities that have only limited U.S. ties).

In the context of public buyout transactions in the UK involving debt finance, a key issue will be to ensure compliance with the "certain funds" and cash confirmation requirements of the UK Takeover Code. These principles require that a bidder have the funds and resources in place on a certain funds basis to finance a proposed acquisition, prior to the public announcement of any bid (and the bidder's financial advisor must confirm the availability of such funds). In practical terms, this means that the bidder and its lenders will need to finalise and have executed the required loan documentation (and satisfy, subject to limited exceptions, the conditions precedent to the loan) at the bid stage.

The "certain funds" concept has also increasingly permeated and become a feature of private buyout transactions. Although not a legal requirement in this context, in practical terms, this means that in certain private buyout transactions, lenders will be required to confirm upfront the satisfaction of all of their financing conditions and agree to disapply loan drawstop events (other than certain limited exceptions) until after the closing of the acquisition.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

The trends recently have been mainly in favour of the borrower/sponsor side. We are seeing ever more flexibility in the additional debt baskets and EBITDA cure rights are back in force in European deals. There are one or two areas where the lenders have pushed back, however, for example there is now usually a cap on the amounts that can be added to EBITDA by way of future synergies on an acquisition or group initiative. As a general comment it is fair to say that the unitranche lenders are a little more conservative than bank lenders, perhaps reflecting the fact that they are more likely to hold the debt rather than to syndicate it away.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

At a high level, the primary tax focus is to establish a tax-efficient structure and, in particular, mitigate tax leakage on payment flows from the underlying portfolio companies through the acquisition structure to investors.

From an investor perspective, withholding tax is often a material factor. However, since the UK applies no withholding to dividends or capital gains, withholding tax concerns in UK transactions tend to focus on interest and the ability to reduce the 20% rate of interest withholding through treaty relief or otherwise (which can be relevant to both external and investor-related debt).

Achieving the maximum deductibility of interest expense on financing remains an important area. In addition to long-standing restrictions on the deductibility of interest (such as under the thin capitalisation rules), relatively recently introduced interest barrier rules (which generally restrict interest deductions to 30% of EBITDA) and anti-hybrid rules provide further limitations, particularly where U.S. investors are concerned.

From a management perspective, the key objective is to minimise income tax on acquisition of shares and to achieve capital gains tax treatment on an exit (see questions 9.2 and 9.3 below).

UK transactions tend to utilise UK incorporated and resident companies in the acquisition structure although non-UK incorporated but UK tax resident companies are sometimes preferred for stamp duty efficiency.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Although recent legislation has introduced adverse changes to the tax treatment of carried interest, capital gains tax (at 28%) remains available on carried interest returns in certain circumstances. Management will look to ensure that carried interest is not treated as income for tax purposes under the "disguised investment management fee" ("DIMF") or income-based carried interest rules.

For equity investment/co-investment, senior management may be able to claim entrepreneurs' relief (delivering a 10% rate of capital gains tax on sale) provided certain conditions are satisfied. In particular, to be eligible, an executive must hold at least 5% of the ordinary share capital. Following recent technical changes and HM Revenue & Customs ("HMRC") guidance on the meaning of what constitutes ordinary share capital, particular focus should be given to the share capital of the company and rights of the management share classes and other investors.

Growth shares and deferred/vesting arrangements remain relevant in the UK and are commonly used as a means of delivering capital gains tax treatment on a future sale with a minimal income tax charge on acquisition.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

Management will generally be keen to ensure that tax is deferred

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until any disposal proceeds are received and will want to maximise the availability of entrepreneurs' relief. Reorganisation reliefs are often available to escape a taxable disposal occurring on a rollover. Loan notes are frequently used for these purposes. A tax clearance will generally be required from HMRC in connection with any tax-neutral rollover and should be factored into the transaction timing.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

As is the case in most other jurisdictions, the UK tax rules have changed significantly in recent years in response to the OECD's Base Erosion and Profit Shifting ("BEPS") project. Particular measures likely to impact the private equity industry include:

(a) The anti-hybrid rules which potentially disallow deductions for interest and other expenses in structures involving hybrid entities or instruments. The rules are commonly a cause of uncertainty in transactions involving U.S. investors where check the box elections have been made through the acquisition structure. This measure, together with (b) below, has led to the increasing use of preference shares rather than debt as a source of investor finance.

(b) The interest barrier rules (see question 9.1 above).

(c) The changes to the availability of double tax treaty relief as a consequence of the adoption of the OECD's multi-lateral instrument ("MLI") which overlays the application of the UK's tax treaties with other participating jurisdictions. This has led to the increasing need for "substance" in entities seeking treaty benefits.

On an international level, despite proposed Brexit, the UK intends to adopt the mandatory disclosure rules proposed by the sixth amendment to the EU Directive on Administrative Cooperation ("DAC6"), which will require the private equity industry and its advisers to consider whether transactions will be subject to mandatory disclosure to HMRC.

On a domestic level, the corporate loss restrictions introduced in April 2017 limit the brought forward losses which can be used by a company within a tax year and present additional challenges to general partner companies in private equity fund structures. Further, the DIMF and income-based carried interest rules (see question 9.2 above) have further limited the circumstances in which capital gains tax treatment can be achieved by management in respect of carried interests. Recent changes to entrepreneurs' relief also need to be considered by those advising management teams (see question 9.2 above).

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

As outlined in the previous answers to the questions in this article, a range of UK and European laws affect PE investors and transactions. Among the most important of these is the Companies Act 2006 (which provides the basic framework of company law in England), the Financial Services and Markets Act 2000 (providing the basic framework of law relating to financial services in the UK), the Bribery Act 2010 (legislation aimed at prohibiting bribery and corruption by UK businesses and individuals worldwide), the GDPR (which governs the transmission and collection of data in Europe) and the Takeover Code (referred to above).

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

PE funds (like other funds) that are managed from or marketed within EU Member States will generally be subject to some, or all, of the rules of the Alternative Investment Fund Managers Directive ("AIFMD") (an EU directive that looks to place hedge funds, private equity and any other alternative investment firms into a regulated framework, in order to monitor and regulate their activity).

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

Especially given that when buying assets from other PE sponsors, they may not benefit from substantive warranty protection as to the condition of the business being sold to them, PE sponsors typically require detailed legal due diligence processes to be undertaken on the assets they are considering buying. These investigations will review most legal and business aspects of the target, including (but not limited to) investigations into title, assets, material contracts, intellectual property, litigation, real estate, and compliance. These investigations tend to be conducted on an issues-focused "red-flag" basis, and to be governed by materiality thresholds aligned to the size of the deal in question.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

Anti-bribery legislation has further increased the focus of PE sponsors on the day-to-day business activities of the targets they are acquiring, and their sensitivities to various business practices and corporate conduct. This trend (driven, for instance, by the Bribery Act 2010 in the UK), has impacted the thoroughness of due diligence investigations, the strength of related W&I provisions in purchase documentation, the day-to-day governance rights insisted upon by PE sponsors, and in some cases, the abandonment of proposed transactions due to insurmountable bribery or corruption issues in the relevant targets.

10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

In general, under English law, a shareholder is not liable for the underlying activities/liabilities of the company to which the shares relate. There are only very specific instances where a PE sponsor may be held liable for its portfolio company. One such example (with reference to the answer to question 10.4 above), is that a PE sponsor could incur liability under the Bribery Act 2010 liability for failing to implement adequate procedures for its portfolio company,

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and potentially under the UK Proceeds of Crime Act 2002 (the relevant "proceeds" of the crime of the bribery concerned being the investment proceeds enjoyed by the PE sponsor from the investee company).

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

The UK remains a premier place in the world for investment by PE sponsors. It should be noted, however, that the uncertainty to the financial environment imposed by the outcome of the Brexit referendum in 2016 (and the consequent uncertainty as to the UK's place in the European Union) means that when making private equity investments in the UK, inevitable uncertainties have now arisen as to the governing legislation and tax rates in the UK which might prevail at the time of a desired exit from that investment (although it should be noted that there would be no particular incentive for the UK government to worsen the UK's status as a destination for international investment following a departure from the European Union). Aside from Brexit, many other factors remain which can influence investments by private equity sponsors in the UK and there is not room to cover them all here. Another topic which is receiving some prominence in the UK at the time of writing is a greater desire for transparency around fees charged by private equity funds, and general levels of disclosure about the investments that they make.

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

U.S. private equity ("PE") deal activity in 2018 increased in terms of both deal volume and value relative to 2017, while deal activity for the first quarter of 2019 declined sharply in both respects relative to the same period in 2018. Deal activity contrasts with PE fundraising, which increased during 2018 to reach record levels and remained strong during the first quarter of 2019. During the past 18 months, PE sponsors have continued to be confronted with extremely elevated valuations for new platform companies and seller-friendly terms created by expedited, competitive auctions. These valuations, coupled with the lack of suitable targets, have created a challenging investment environment for buyers that has persisted during this period and negatively impacted deal activity. As a result, activity during this period has increased for portfolio company add-ons and alternative transactions such as carve-outs, strategic partnering transactions, minority investments, club deals and take-private transactions. In addition, PE sponsors have focused significant attention on readying existing portfolio companies for exits at today's high valuations.

Non-traditional PE funds such as sovereign wealth funds, pension plans and family offices are extending beyond minority positions to increasingly serve as lead investors in transactions, which has created additional competition for traditional PE funds.

1.2 What are the most significant factors encouraging or inhibiting private equity transactions in your jurisdiction?

The dearth of suitable targets has resulted in extremely competitive auctions, which in turn has resulted in high historical selling multiples and seller-favorable terms. Successful bids often include "walk-away" terms with few conditions and recourse limited solely to buyer-obtained representation and warranty ("R&W") insurance. With bankers and sellers focused on certainty and speed to closing, transactions are often required to be signed and closed within days or a few weeks. Recent regulatory reforms involving the Committee on Foreign Investment in the United States ("CFIUS") could lead to increased timing delays and deal uncertainty for transactions involving non-U.S. investors that might raise U.S. national security issues.

1.3 What trends do you anticipate seeing in (i) the next 12 months and (ii) the longer term for private equity transactions in your jurisdiction?

Despite the potential for continued market turbulence and economic uncertainty, PE investment activity will likely remain active due to record access to capital. Over the past few years, the concentration of capital in large funds has increased, leading to a corresponding increase in the number of megadeals consummated. We expect this trend to continue as valuations remain high, while other funds increase the number of add-on and alternative transactions pursued in order to deploy capital quickly in a competitive market.

In addition, pension funds, insurance companies and other investors of large pools of capital will likely increase their allocation to alternative investments – PE, private debt, real estate and infrastructure.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

The most common acquisition structures are mergers, equity purchases and asset purchases in the case of private targets, and one-step and two-step mergers in the case of public targets.

Historically, most PE sponsors have prioritized control investments, but the current market has increased focus on alternative investment structures.

2.2 What are the main drivers for these acquisition structures?

The primary drivers include tax considerations, stockholder approval, speed and certainty of closing and liability issues.

Mergers offer simple execution, particularly where the target has numerous stockholders, but buyers lack privity with the target's stockholders, and the target's board may expose itself to claims by dissatisfied stockholders. Buyers often seek separate agreements with stockholders that include releases, indemnification and restrictive covenants. However, depending on the applicable state law, enforceability issues may arise.

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Stock purchases require all target stockholders to be party to and support the transaction. These agreements avoid privity and enforcement concerns that arise in a merger but may be impractical depending on the size and character of the target's stockholder base.

Asset purchases provide favorable tax treatment because buyers can obtain a step-up in tax basis in acquired assets. See section 9. Depending on the negotiated terms, buyers also may leave behind existing liabilities of the target. However, asset purchases (especially carve-out transactions) can be difficult and time-consuming to execute because third-party contract consents may be required. In addition, buyers need to carefully review the business' assets and liabilities to ensure that all necessary assets are acquired and that liabilities that flow to buyers as a matter of law are not unwittingly inherited.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

U.S. PE returns typically arise from management fees and returns on equity investments. Equity structuring varies depending on the PE sponsor involved, the portfolio company risk profile and the IRR sought. Equity is most often comprised of preferred and/or common equity interests held by the PE sponsor. Often, some or each type of equity is offered to existing or "rollover" target investors. Preferred equity can be used to set minimum returns and incentivize common or other junior security holders to drive portfolio company performance. PE funds often offer portfolio company management equity-based incentive compensation in the form of stock options, restricted stock, phantom or other synthetic equity or profits interests, each of which is subject to vesting requirements. Carried interests are typically found at the fund level and do not directly relate to the structuring of the equity investment at the portfolio company level.

The main drivers for these structures are (i) alignment of interests among the PE sponsor and any co-investors, rollover investors and management, including targeted equity returns, (ii) tax efficiency for domestic and international fund investors and other portfolio company investors, including management, and (iii) incentivizing management.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

Minority investments create financial and legal issues not often encountered in control investments. Unlike control transactions, where the PE sponsor generally has unilateral control over the portfolio company, minority investors seek to protect their investment through contractual or security-embedded rights. Rights often include negative covenants or veto rights over major business decisions, including material M&A transactions, affiliate transactions, indebtedness above certain thresholds, annual budgets and business plans, strategy, senior management hiring/firing and issuance of equity. In addition, PE sponsors will seek customary minority shareholder protections such as board and committee representation, information and inspection rights, tag-along and drag-along rights, registration rights and pre-emptive rights.

For transactions subject to CFIUS review, non-U.S. PE investors taking a minority position might consider foregoing certain rights that it otherwise would seek (e.g., board representation and access to non-public information) in order to avoid triggering CFIUS review or to otherwise facilitate obtaining CFIUS clearance.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

Management equity is typically subject to time- and/or performance-based vesting. Time-based awards vest in specified increments over several years (typically four to five years (in the Eastern United States) and sometimes less (in the Western United States)), subject to the holder's continued employment. Performance-based awards vest upon achieving performance goals, often based on the PE sponsor achieving a certain IRR or invested capital multiple upon exit. Time-based awards typically accelerate upon PE sponsor exit. Forfeiture of both vested and unvested equity in the event of a termination for cause is not uncommon.

Compulsory acquisition provisions are not typical, but portfolio companies customarily reserve the right to repurchase an employee's equity in connection with termination at FMV or the lesser of FMV and original purchase price, depending on the timing and reason for termination.

The proportion of equity allocated to management (as well as the allocation among executives) varies by PE fund and portfolio company, but management equity pools for portfolio companies commonly range from 8%–13% of equity on a fully-diluted basis.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

Management equity holders are typically treated as good leavers if their employment is terminated without cause, they resign with good reason or after a specified period of time, or their employment terminates due to death or disability. Bad leavers are commonly those who are terminated for cause or who otherwise resign without good reason.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

PE sponsors generally form new buyer entities (most often corporations or tax pass-through entities such as limited liability companies ("LLCs") or limited partnerships) through which they complete acquisitions and maintain their ownership interest in underlying portfolio companies. Governance arrangements are typically articulated at the portfolio company level where management holds its investment but may also be found at the buyer level if co-investors or management investors hold equity interests in the buyer. For control investments, PE sponsors will often control the manager and/or the board of both the buyer and the portfolio company.

Governance agreements among PE sponsors, co-investors and management will most commonly be in the form of a shareholders' agreement or LLC agreement. These agreements ordinarily contain (i) transfer restrictions, (ii) rights of first refusal, (iii) tag-along and drag-along rights, (iv) pre-emptive rights, (v) rights to elect the manager or board of directors, (vi) information rights, (vii) special rights with respect to management equity, including repurchase rights, and (viii) limits on certain duties to the extent permitted by

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state law. For larger portfolio companies contemplating exits through IPOs, registration rights may also be sought. Governance arrangements are not generally required to be made publicly available unless the portfolio company is a public reporting company. Charters are required to be filed with the state of organization but generally do not include meaningful governance provisions.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

For control investments, PE sponsors will often control the portfolio company through their rights to appoint the manager or a majority of the board. As a result, major corporate actions are ultimately indirectly controlled by the PE sponsor. Veto rights will generally not be included in underlying governance arrangements unless the PE sponsor owns a substantial minority position. See question 2.4.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

Veto rights are typically contractual rights in favor of the shareholder contained in shareholders' agreements or LLC agreements and are generally enforceable. For corporations, although less common, negative covenants can also be included in the articles of incorporation, which would render any action taken in violation of one of those restrictions *ultra vires*. Although shareholder-level veto rights are sometimes employed, director-level veto rights are less common, as veto rights exercised by directors will be subject to their overriding fiduciary duty owed to the portfolio company. See question 3.6.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or *vice versa*)? If so, how are these typically addressed?

Whether a PE investor owes duties to minority shareholders requires careful analysis and will depend upon several factors, including the legal form of entity involved and its jurisdiction of formation.

Several jurisdictions hold that all shareholders in closely held companies owe fiduciary duties to each other and the company. In other jurisdictions, such as Delaware, only controlling shareholders owe fiduciary duties. In this context, the ability to exercise dominion and control over corporate conduct (even if less than 50% of the equity is owned) will be determinative.

Delaware is frequently chosen as the state of organization in PE transactions due to its well-developed business law and sophisticated judiciary. Under Delaware law, duties arising from controlling ownership include fiduciary duties of care and loyalty and other duties such as those arising under the corporate opportunity doctrine. The duty of care requires directors to make informed and deliberate business decisions. The duty of loyalty requires that decisions be in the best interests of the company and its stockholders and not based on personal interests or self-dealing. For corporate entities, these duties may not be waived.

For PE sponsors organizing their investment vehicles as LLCs in Delaware, the underlying LLC agreement will often include an express waiver of fiduciary duties owned to minority investors. Absent an express waiver, courts will apply traditional corporate-like fiduciary duties. Other duties deemed included in LLC agreements such as duties of good faith and fair dealing may not be waived. In addition, shareholders' and LLC agreements often include express acknowledgments that the PE sponsor actively engages in investing and has no obligation to share information or opportunities with the portfolio company.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Shareholders' and LLC agreements are generally governed by and must be consistent with the laws of the state of formation. LLC agreements, which are contracts among the company and its members, provide greater flexibility than shareholders' agreements. Although governing law and submission to jurisdiction provisions may refer to the law of other states, or may apply the law of two or more states through bifurcation provisions, this approach is unusual and should be avoided, as it is unduly complicated and references to non-formation state laws may render certain provisions unenforceable.

Non-competition and non-solicitation provisions in shareholders' and LLC agreements generally restrict management and non-PE co-investors, but not PE investors. These provisions are subject to the same enforceability limitations as when contained in other agreements. Enforceability will be governed by state law and must be evaluated on a case-by-case basis. The agreements must be constructed to protect the legitimate interests of the portfolio company and not violate public policy. Unreasonable temporal and geographic scope may render provisions unenforceable or subject to unilateral modification by courts.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

There are no meaningful legal restrictions applicable to PE investors nominating directors to private company boards, other than restrictions under applicable antitrust laws. For example, the Clayton Act generally prohibits a person from serving as an officer or director of two competing corporations. Recently, the U.S. Department of Justice (the "DOJ") expressed a desire to extend the scope of these restrictions on interlocking directorships to non-corporate entities and entities that appoint directors to competing entities as representatives or "deputies" of the same investor. If the Clayton Act is expanded in such a manner, PE funds may need to reevaluate their existing corporate governance arrangements with their portfolio companies.

Potential risks and liabilities exist for PE-sponsored directors nominated to boards. Directors appointed by PE investors should be aware that they owe fiduciary duties in their capacity of directors. Directors cannot delegate their decision-making responsibility to or defer to the wishes of a controlling shareholder, including their PE sponsor. In addition, conflicts of interest may arise between the PE

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firm and the portfolio company. Directors should be aware that they owe a duty of loyalty to the company for the benefit of all of its shareholders (subject to certain exceptions in the case of an LLC where fiduciary duties of directors are permitted to be, and have been, expressly disclaimed) and that conflicts of interest create exposure for breach of duty claims. Finally, directors may owe fiduciary duties to certain creditors of the portfolio company in the event such entity is insolvent or within the zone of insolvency.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

See question 3.6. Under the duty of loyalty, directors must act in good faith and in a manner reasonably believed to be in the best interests of the portfolio company for the benefit of its shareholders and may not engage in acts of self-dealing. In addition, directors appointed by PE firms who are also PE firm officers owe potentially conflicting fiduciary duties to PE fund investors. Directors need to be cognizant of these potential conflicts and seek advice of counsel.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust and other regulatory approval requirements, disclosure obligations and financing issues?

The timetable generally depends on the due diligence process, negotiation of definitive documentation, and obtaining debt financing, third-party consents and regulatory approvals.

Antitrust clearance is the most common regulatory clearance faced. Generally, only companies that meet regulatory thresholds are required to make filings under the Hart-Scott-Rodino Act ("HSR"). The most significant threshold in determining reportability is the minimum size of transaction threshold (2019: US$90 million). In most circumstances, the HSR process takes approximately one month and is conducted between signing and closing. However, parties can expedite review by filing based on executed letters of intent or by requesting early termination of the waiting period.

Transactions raising anticompetitive concerns may receive a "second request" from the reviewing agency, resulting in a more extended review period.

In addition, parties to transactions potentially affecting national security may seek regulatory clearance from CFIUS. Given recent political developments, buyers should expect enhanced scrutiny by the U.S. government of certain foreign investments in the United States, particularly in the technology and defense-related industries. In addition, recent CFIUS reforms that have been implemented pursuant to the Foreign Investment Risk Review Modernization Act of 2018 ("FIRRMA") now require mandatory submissions to CFIUS for certain types of transactions that are more likely to raise U.S. national security concerns – previously, CFIUS was typically a voluntary process. Prudent buyers seek CFIUS approval to forestall forced divestiture orders.

Other contractual or government approvals relating to specific sectors or industries (e.g., the Jones Act) may also be necessary or prudent depending on the nature of the business being acquired or the importance of underlying contracts.

4.2 Have there been any discernible trends in transaction terms over recent years?

Over the past few years, competitive auctions have become the preferred method for exits by PE sponsors and other sellers in the United States. As a result of these competitive auctions, the scarcity of viable targets and the abundant availability of equity and debt financing, transaction terms have shifted strongly in favor of sellers, including the limiting of conditionality and post-closing indemnification obligations. Transactions are generally being consummated with "public"-style closing conditions (i.e., representations subject to MAE bring-down), financing conditions have virtually disappeared, and reverse break fees are increasingly common. The use of R&W insurance has been implemented across transactions of all sizes and is now used equally by PE and strategic buyers. Transactions are being structured more frequently as walk-away deals, with the insurance carrier being responsible for most breaches of representations between the deductible and cap under the policy. It also is becoming more common to include terms regarding CFIUS in transactions involving non-U.S. investors.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

Public company acquisitions pose a number of challenges for PE sponsors. The merger proxy or tender offer documents provided to target shareholders will include extensive disclosure about the transaction, including the buyer and its financing and a detailed background section summarizing the sale process and negotiations. These disclosure requirements are enhanced if the Rule 13e-3 "going private" regime applies to the transaction.

A public company acquisition will require either consummation of a tender offer combined with a back-end merger or target shareholder approval at a special shareholder meeting. In either case, there will be a significant delay between signing and closing that must be reflected in sponsor financing commitments, with a minimum of six weeks for a tender offer (which must be open for 20 business days) and two to three months for a merger that requires a special meeting.

Absent unusual circumstances, there will be no ability to seek indemnification or other recourse for breaches of target representations or covenants, but R&W insurance can be acquired.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

Generally, the acquisition of a U.S. public company is subject to the ability of the target's board to exercise a "fiduciary out" to pursue superior offers from third parties until the deal is approved by the target shareholders or a tender offer is consummated. A PE buyer typically negotiates an array of "no shop" protections that restrict the target from actively soliciting competing bids, along with matching and information rights if a third-party bid arises. If a target board exercises its fiduciary out to terminate an agreement and enter into an agreement with an unsolicited bidder, or changes its recommendation of the deal to shareholders, break-up fees are customary. Fees typically range from 2%–4%.

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6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

U.S. PE buyers typically purchase companies on a cash-free debt-free basis. As opposed to a locked box approach, U.S. transactions typically involve a working capital adjustment where the parties agree to a target amount that reflects a normalized level of working capital for the business (often a trailing six- or 12-month average) and adjust the purchase price post-closing to reflect any overage or underage of working capital actually delivered at closing. Depending on the nature of the business being acquired and the dynamics of the negotiations, the price may also include earn-outs or other contingent payments that provide creative solutions to disagreements over the target's valuation.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

With the increasing prevalence of R&W insurance, post-closing indemnification by sellers, which was once intensely negotiated, has become less important for allocating risk between buyers and sellers. Historically, sellers would indemnify buyers for breaches of representations and warranties, breaches of covenants and pre-closing tax liabilities, and the parties would carefully negotiate a series of limitations and exceptions to the indemnification.

When buyers obtain R&W insurance, sellers typically provide only limited indemnification for a portion of the retention under the policy (e.g., 50% of a retention equal to 1% of enterprise value). Public-style walk-away deals are increasingly common, and proposing a walk-away deal provides bidders an advantage in competitive auctions.

For issues identified during due diligence, buyers may negotiate for special indemnities, with the terms depending on the nature and extent of the exposure and the parties' relative negotiating power.

Management team members typically do not provide any special indemnification to buyers in their capacity as management.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

Historically, U.S. PE sellers typically have not agreed to non-competition covenants, and restrictive covenants were limited to employee non-solicitation covenants. Conversely, selling management investors and certain co-investors typically agree to non-competition and other restrictive covenants. Recently, limited non-competition covenants by PE sellers have become more common given the high valuations paid by buyers. However, these covenants are typically very narrow and may be limited to restrictions on purchasing enumerated target companies. Restrictive covenants by PE sellers tend to be intensely negotiated, and the terms, including the length of the restrictions, any exceptions and applicability to PE fund affiliates, depend on the parties' negotiating strength and the nature of the PE seller and the business being sold.

Counsel should ensure that non-selling members of the target's management team continue to be bound by existing restrictive covenants.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

PE and other sophisticated sellers routinely request that recourse be limited to R&W insurance obtained by buyers.

Policy terms commonly include coverage limits of 10%–15% of target enterprise value, a 1% retention (stepping down to 0.5% after one year), six years of coverage for breaches of fundamental representations and three years for other representations. Exclusions include issues identified during due diligence, certain liabilities known to the buyer, benefit plan underfunding and certain environmental liabilities, and may also include industry and deal specific exclusions based on areas of concern arising during the underwriting process.

Pricing of policies has grown more favorable in recent years, with premiums commonly around 3% or less of the policy limit and underwriting due diligence fees of US$25,000–US$50,000. In addition, the premium is subject to taxation under state law, and the insurance broker will also collect a fee.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

Representations and warranties typically survive for 12–24 months post-closing, with 12 months increasingly becoming the norm, although certain specified representations may survive longer. For example, tax, employee benefit and fundamental representations often survive until expiration of the applicable statute of limitations. Fundamental representations typically include due organization, enforceability, ownership/capitalization, subsidiaries and brokers.

For transactions without R&W insurance, indemnification caps typically range from 5%–20% of the purchase price, whereas a significantly lower cap (e.g., 1%) is typically negotiated when the buyer is obtaining R&W insurance. Liability for breaches of fundamental representations, breaches of covenants and fraud is often uncapped. Sellers will often only be responsible for damages above a basket amount.

6.6 Do (i) private equity sellers provide security (e.g. escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

With the continuing increase in usage of R&W insurance, escrows and holdbacks to cover indemnification for representation breaches are becoming less common. However, for non-walk-away deals, sellers generally place 50% of the retention under the R&W insurance policy in escrow. Escrows for post-closing purchase price adjustments remain common.

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6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buying entity (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

U.S. PE buyers typically fund acquisitions through a combination of equity and third-party debt financing. The PE sponsor will deliver an equity commitment letter to the buyer under which it agrees to fund a specified amount of equity at closing, and the seller will be named a third-party beneficiary. In a club deal, each PE sponsor typically delivers its own equity commitment letter.

Committed lenders will deliver debt commitment letters to the buyer. Often, PE buyers and their committed lenders will limit sellers' rights to specifically enforce the debt commitment. See question 6.8.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

In the current market, closings are rarely, if ever, conditioned on the availability of a buyer's financing. In certain circumstances, PE buyers may accept the risk that they could be forced to close the transaction by funding the full purchase price. However, buyers seeking to limit such exposure typically negotiate for a reverse break fee, which allows termination of the transaction in exchange for payment of a pre-determined fee if certain conditions are satisfied. Depending on the terms, reverse break fees may also be triggered under other circumstances, such as a failure to obtain HSR approval. Typical reverse break fees range from around 4%–10% of the target's equity value, with an average of around 6%–7%, and may be tiered based on different triggering events. Where triggered, reverse break fees typically serve as a seller's sole and exclusive remedy against a buyer. Given that PE buyers typically have no assets prior to equity funding at closing, sellers commonly require sponsors to provide limited guarantees of reverse break fees.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

Exits through IPOs will often be at higher multiples and more readily apparent market prices than exits through third-party sale transactions. However, exits through IPOs are subject to volatile market conditions and present other significant considerations.

Unlike third-party sales, PE sponsors continue to own significant amounts of portfolio companies' equity post-IPO. As a result, PE sponsors' ownership interests and rights and the nature of affiliate transactions with portfolio companies will be subject to public disclosure and scrutiny. PE sponsor management and monitoring agreements commonly terminate in connection with IPOs.

Seeking to retain control over their post-IPO stake and ultimate exit, PE sponsors often obtain registration rights and adopt favorable bylaw and charter provisions, including board nomination rights, permitted stockholder action by written consent and rights to call special stockholder meetings. Because many U.S. public companies elect board members by plurality vote, PE sponsors often retain the right to nominate specific numbers of directors standing for reelection following the IPO. Absent submission of nominees by third-party stockholders through proxy contests, which are unusual in the United States, PE sponsors can ensure election of their nominees. As these favorable PE rights are unusual in U.S. public companies, the rights often expire when the sponsor's ownership falls below specified thresholds.

Unlike private companies, most U.S. public companies are subject to governance requirements under stock exchange rules such as independent director requirements.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

The underwriters in an IPO typically require PE sellers to enter into lock-up agreements that prohibit sales, pledges, hedges, etc. of shares for 180 days post-IPO. Following expiration of the lock-up period, PE sponsors will continue to be subject to legal limitations on the sale of unregistered shares, including limitations on timing, volume and manner of sale.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

Increasingly, PE sponsors are simultaneously pursuing exit transactions through IPOs and private auction sales. Dual-track transactions often maximize the price obtained by sellers (through higher IPO multiples or increased pricing pressure on buyers), lead to more favorable transaction terms and provide sellers with greater execution certainty. The path pursued will depend on the particular circumstances of the process, but ultimate exits through private auction sales remain most common.

Dual-track strategies have historically depended on the size of the portfolio company and attendant market conditions. Dual-track approaches are less likely for small- to mid-size portfolio companies, where equity values may be insufficient to warrant an IPO. In addition, such companies are less likely to have sufficient resources to concurrently prepare for both an IPO and third-party exit. As volatility in IPO markets increases, PE firms generally focus more on sales through private auctions where closing certainty and predictable exit multiples are more likely.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (particularly the market for high yield bonds).

The most common debt sources are bank loans, private debt (known as "direct lending") and high-yield bonds. Debt is categorized by its place in the capital structure and the associated risk to the lender. Senior debt ranks above all other debt and equity of the business and is first in line for repayment. Senior secured debt includes revolving facilities, with advances made on the basis of borrowing bases (asset-based loans) or cash flow, and term debt. Second lien or junior lien loans are equal in right of payment to holders of senior

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secured debt but rank behind such holder's security in the assets of the business. Mezzanine and other subordinated debt is subordinated in right of payment to holders of senior debt, often unsecured and sometimes includes equity kickers. Unitranche facilities combine senior and subordinated debt in one facility, typically with a blended rate of interest.

Leveraged loans are currently favored over high-yield bonds due to competitive pricing, similar flexible covenant terms, ease of amendment and limited prepayment premiums.

Direct lenders have become important market players due to their competitive advantage over traditional bank lenders, who have been constrained by capital requirement guidelines. The current atmosphere of bank deregulation will reduce this advantage, but borrowing from direct lenders will continue to be a trend in light of the amount of money in the market generally and such lenders' flexibility in commitment amounts and loan terms.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

The current U.S. administration aims to loosen regulations applicable to traditional lenders. In 2013, the Interagency Guidance on Leveraged Lending (the "LLG") was introduced and provided limits on *pro forma* leverage for leveraged financings at 6× and also required that borrowers be able to amortize at least 50% of their debt within five to seven years of closing. Recent statements from U.S. agencies clarified that banks no longer need adhere to the LLG as it is guidance and no enforcement action will be taken based on it.

The latest target of the current push for deregulation is the Dodd-Frank Act, including the Volcker Rule, a regulation that was meant to prohibit banks from making speculative bets with their own capital. The result of this push was a roll-back of Dodd-Frank regulations which eased regulations on "small" banks. The roll-back includes a range of regulatory relief for community banks, including an exemption from the Volcker Rule, and relief from enhanced prudential standards for mid-size banking organizations.

8.3 What recent trends have there been in the debt financing market in your jurisdiction?

Recent trends in the U.S. loan market are consistent with increases in borrower friendly provisions and include the following:

Incremental and Incremental Equivalent Debt Capacity: Borrowers are able to incur incremental and incremental-equivalent debt equal to the sum of (1) the greater of a fixed dollar amount or grower based on an agreed upon percentage of EBITDA, (2) prepayment amounts (including loan buybacks), and (3) unlimited amounts if an applicable leverage test (depending on whether the debt to be incurred is senior, junior lien or unsecured debt) is met or a "not worse than" leverage test if the debt incurred will be used for an acquisition. Debt incurred using the ratio prong is typically calculated first prior to the use of the "freebie" or any other basket. Debt incurred under the "freebie" basket may be reclassified to the ratio prong at a later date if the leverage tests then are met.

Excess Cash Flow Sweeps: Borrowers are able to reduce excess cash flow sweeps by expenditures paid for with revolving debt in addition to the use of internally generated cash. Sweep percentages increasingly have coalesced at no more than 50% of excess cash flow (with stepdowns to 25% and 0%, subject to leverage governors), and some deals include a *de minimis* basket before application of the sweep. Debt prepayments made before the required payment date for the sweep but after the applicable fiscal period often count to reduce the amount required to be paid towards the sweep.

Available Amount Baskets: Borrowers are able to use an "available amount" basket with limited conditionality to make investments, restricted payments and subordinated or junior lien debt payments. Available amount baskets often start with a basket of the greater of a fixed dollar amount or grower based on an agreed upon percentage of EBITDA and increase by 50% of Consolidated Net Income or the retained portion of excess cash flow. The available amount further grows through equity contributions, returns on investments and "declined proceeds" from the excess cash flow sweep.

Unlimited Permitted Acquisitions: Borrowers may complete unlimited acquisitions, subject to limited conditionality such as a leverage test at the time the acquisition agreement is executed.

Change of Control: Sponsors are increasingly focused on loan portability (and related conditionality), whereby sponsors can sell their equity interests in a portfolio company without the need for the buyer to refinance a favorable existing loan agreement. Parameters typically include a leverage test and may include time limitations and minimum equity requirements.

In addition to the foregoing, lenders increasingly are seeking assurances from transaction parties related to CFIUS review and approval.

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

For non-U.S. investors, considerations include structuring the fund and investments in a manner that prevents investors from having direct exposure to U.S. net income taxes (and filing obligations) and minimizes U.S. tax on dispositions or other events (e.g., withholding taxes). Holding companies ("blockers") are often used and, in some cases, domestic statutory exceptions or tax treaties may shield non-U.S. investors from direct exposure to U.S. taxes.

For U.S. investors, considerations include minimizing a "double tax" on the income or gains and, in the case of non-corporate U.S. investors, qualifying for reduced tax rates or exemptions on certain dividend and long-term gains.

There is also a focus in transactions on maximizing tax basis in assets and deductibility of costs, expenses and interest on borrowings, as well as state and local income tax planning.

9.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Tax-efficient arrangements depend on portfolio company tax classification. For partnerships (including LLCs taxed as partnerships), profits interests can provide meaningful tax efficiencies for management. Profits interests are granted for no consideration and entitle holders to participate only in company appreciation (not capital), and provide holders with the possibility of reduced tax rates on long-term capital gains (but do have certain

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complexities not present in less tax-efficient alternatives). Other types of economically similar arrangements (non-ISO stock options, restricted stock units and phantom equity) do not generally allow for this same capital gain treatment.

Profits interests are not available for corporations. In certain cases, the use of restricted stock that is subject to future vesting (together with the filing of an 83(b) election) can enable a holder to benefit from reduced tax rates on long-term capital gains.

9.3 What are the key tax considerations for management teams that are selling and/or rolling-over part of their investment into a new acquisition structure?

Management investors selling their investment focus on qualifying for preferential tax rates or tax exemptions on income.

Management investors rolling part of their investment seek to roll in a tax-deferred manner, which may be available depending on the nature of the transaction and management's investment. In some cases (such as phantom or restricted stock unit plans), tax deferral is not achievable or may introduce significant complexity.

9.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

In 2017, the United States enacted significant tax reform, commonly referred to as the Tax Cuts and Jobs Act. In addition, prior to this reform, the United States made significant changes to the tax audit process by the U.S. Internal Revenue Service ("IRS") for entities treated as partnerships under U.S. tax law.

Relevant provisions of this tax reform for PE funds and their portfolio companies (many of which are temporary) include: (i) reductions in the corporate tax rate; (ii) limitations on interest expense deductibility and the use of net operating losses; (iii) 100% expensing of the cost of certain property in the year placed in service; (iv) lengthening (to three years) the holding period for long-term capital gains for carried interest granted with respect to real estate or investment businesses; and (v) significant changes to international taxation of U.S. taxpayers.

The new partnership audit rules provide the IRS with a mechanism to assess and collect income tax deficiencies arising from partnership tax audits to result in partnership-level liability (rather than partner-level liability).

10 Legal and Regulatory Matters

10.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

The most significant legislation adopted in 2017 impacting PE sponsors and transactions was the Tax Cuts and Jobs Act. See section 9.

The enactment of FIRRMA in August 2018 has led to significant reforms to CFIUS. In particular, the scope of transactions that could be subject to CFIUS review has been expanded, certain filings are now mandatory, and there is an increased focus on particularly sensitive industries. These changes have led to increased timing delays for transactions that require CFIUS review and increased uncertainty as to whether CFIUS might seek to impose significant measures to mitigate potential national security concerns in a manner that might materially impact the structure of the transaction.

10.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g. on national security grounds)?

There is enhanced scrutiny by CFIUS of transactions involving non-U.S. investors and U.S. businesses that operate in industries that are deemed to be sensitive from a national security perspective. Transactions involving Chinese investors, in particular, are now subject to intense scrutiny by CFIUS. In addition, FIRRMA expanded CFIUS' jurisdiction to enable review not only of investments in which non-U.S. investors might be acquiring control over U.S. businesses (which have always been subject to CFIUS review), but also certain investments in which non-U.S. persons would gain certain rights involving appointment of directors, access to material non-public technical information, or other substantive decision-making board appointment rights even in the absence of control.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)?

The scope, timing and depth of legal due diligence conducted by PE sponsors in connection with acquisitions depends on, among other things, the transaction size, the nature and complexity of the target's business and the overall transaction timeline. Sponsors may conduct certain diligence in-house, but outside counsel typically handles the bulk of legal diligence. Specialized advisers may be retained to conduct diligence in areas that require particular expertise.

10.4 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g. diligence, contractual protection, etc.)?

PE buyers and counsel will evaluate the target's risk profile with respect to anti-bribery and anti-corruption legislation, including the Foreign Corrupt Practices Act ("FCPA"). The risk profile depends on, among other things, whether the target conducts foreign business and, if so, whether any of the business is conducted (i) in high risk regions (e.g., China, India, Venezuela, Russia and other former Soviet countries and the Middle East), (ii) with foreign government customers, or (iii) in industries with increased risk for violations (e.g., defense, aerospace, energy and healthcare). Diligence will be conducted based on the risk profile. Possible violations identified need to be thoroughly evaluated and potentially self-reported to the relevant enforcement authorities.

The DOJ may impose successor liability and sanctions on PE buyers for a target's pre-closing FCPA violations. PE buyers typically obtain broad contractual representations from sellers regarding anti-bribery and anti-corruption matters.

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10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Fundamentally, under U.S. law, businesses operated as legally recognized entities are separate and distinct from owners. Consequently, PE sponsors generally will not be liable for acts of portfolio companies. However, there are several theories under which "corporate" form will be disregarded. These include:

(i) Contractual liability arising to the extent the PE sponsor has agreed to guarantee or support the portfolio company.

(ii) Common law liability relating to (a) veil piercing, alter ego and similar theories, (b) agency and breach of fiduciary duty, and (c) insolvency-related theories. Most often, this occurs when the corporate form has been misused to accomplish certain wrongful purposes or a court looks to achieve a certain equitable result under egregious circumstances.

(iii) Statutory control group liability relating to securities, environmental, employee benefit and labor laws, the FCPA and consolidated group rules under tax laws.

The two most common areas of concern relate to liabilities under U.S. environmental laws and employee benefit laws. The Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") can impose strict liability with respect to releases of hazardous substances at a facility currently or formerly owned or operated by the portfolio company. PE sponsors may be held directly liable as "operators" of the portfolio company's facility when they exercise actual and pervasive control of a portfolio company's facility by actually involving themselves in the portfolio company's daily operations, including environmental activities. Parents can also have indirect or derivative liability for the portfolio company's liability under CERCLA if there is a basis for veil piercing

Under the Employee Retirement Income Security Act ("ERISA"), when a subsidiary employer terminates a qualified defined benefit pension plan, all members of the subsidiary control group become jointly liable. Control groups arise among affiliates upon "the ownership of stock possessing at least 80% of total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of stock of such corporation."

ERISA imposes joint and several liability on any person who, upon termination of a plan, is a contributing sponsor of the plan or a member of the person's controlled group. As a result, all affiliated companies (including the PE sponsor and other portfolio companies) may face liability when an inadequately funded plan terminates, provided that the 80% control test is satisfied.

11 Other Useful Facts

11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Contract law in the United States embraces the freedom to contract. Absent public policy limits, PE sponsors in U.S. transactions are generally able to negotiate and agree upon a wide variety of transaction terms in acquisition documents that satisfy their underlying goals.

Transaction parties should expect increased regulation in the United States. In particular, new regulations should be expected in the arenas of cybersecurity and protection of personal data that will affect both how diligence is conducted and how portfolio companies operate. Taxes continue to be a key value driver in PE transactions, with IRRs and potential risks depending on tax considerations. See section 9.

Increased attention must be paid to potential CFIUS concerns, particularly given recent reforms and the political climate. Non-U.S. PE investors should be aware that investing in a U.S. business might trigger mandatory filing requirements. Even if a filing is not mandatory, it nonetheless may be advisable to submit a voluntary filing in order to avoid deal uncertainty, as CFIUS has the ability to open a review even after closing has occurred and could even require divestment. CFIUS considerations will remain a key issue for PE sponsors regarding foreign investments in 2019. See section 10.

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Dr. Markus P. Bolsinger, co-head of Dechert's PE practice, structures and negotiates complex transactions – domestic and transatlantic M&A, leveraged buyouts, recapitalizations and going-private transactions – and advises on general corporate and corporate governance matters. Dr. Bolsinger's experience extends across industries, including healthcare, industrial, packaging, agribusiness, consumer, food and beverage, and restaurant sectors. His clients have included leading PE firms, such as First Atlantic Capital, ICV Partners, J.H. Whitney & Co., Morgan Stanley Capital Partners and New Mountain Capital. In addition to his core M&A and PE experience, Dr. Bolsinger has extensive expertise in transactional risk insurance, and frequently speaks and writes on the topic in major media outlets.

He has been listed as a recommended lawyer by the U.S., EMEA and Germany editions of *The Legal 500*, a legal directory based on the opinions of clients and peers. Recognized for M&A and PE buyouts in 2018, Dr. Bolsinger has been cited as "a trusted adviser" who "takes the time to understand a client's business and motivations before undertaking any way". Since 2010, every year Dr. Bolsinger has been recognized and received a *pro bono* service award.

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Dechert is a global law firm focused on sectors with the greatest complexities and highest regulatory demands. We deliver practical commercial insight and judgment to our clients' most important matters. Nothing stands in the way of giving clients the best of the firm's entrepreneurial energy and seamless collaboration in a way that is distinctively Dechert.

Dechert has been an active advisor to the private equity industry for more than 30 years – long before it was called "private equity". As a result of our longstanding roots and diverse client base, we have a deep understanding of the latest market terms and trends and provide creative solutions to the most complex issues in evaluating, structuring and negotiating PE transactions. Ranked among the top law firms for PE by prominent league tables and legal directories, Dechert's global team has been recognized for its commercial judgment and client focus.

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