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Private Equity 2021

A practical cross-border insight into private equity law

Seventh Edition

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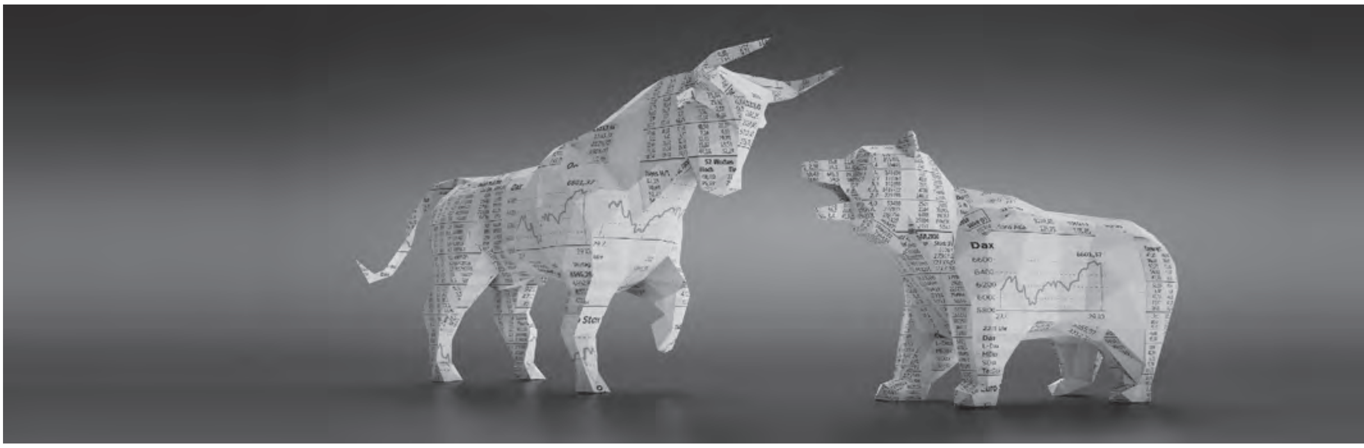

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Private Equity 2021

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Preface

We are privileged to have been invited to introduce the 2021 edition of *ICLG – Private Equity*, one of the most comprehensive comparative guides to the legal aspects of private equity transactions available today. The *Guide* is in its seventh edition, which is itself a testament to its value to practitioners and clients alike. Dechert LLP is delighted to continue to serve as the *Guide*'s editor.

With today's rapidly changing macroeconomic, social and political developments in private equity, it is critical to maintain an accurate and up-to-date guide regarding relevant practices and legislation in a variety of jurisdictions. The 2021 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 framework for private equity transactions in 26 different jurisdictions. This edition also includes four expert analysis chapters, which discuss pertinent issues affecting the private equity industry, transactions and legislation.

The seventh 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 legal aspects of private equity transactions, provided by experienced practitioners from around the world.

Christopher Field & Dr. Markus P. Bolsinger
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2021 and Beyond: Private Equity Outlook for 2022


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I. Introduction

In a year of unprecedented health crises and social upheaval, private equity firms and investors have had to adapt rapidly to sudden and ever-evolving economic conditions and cultural and political norms. With the global economy coming to an immediate and severe standstill at the onset of the COVID-19 pandemic, private equity fundraising and M&A activity halted in the spring of 2020. Almost as suddenly and surprisingly came a rebound in the second half of 2020, as pent-up demand sought new target assets. Private equity deal activity ultimately rose globally in 2020 compared to 2019 in terms of deal value, outpacing the overall M&A market rebound. This rebound has been continuing apace in 2021.

The ramp-up in economic activity has been met by new opportunities, with investors placing new emphasis on sustainable investing and finding new vehicles for portfolio company exits. Contractual issues triggered by the pandemic have also remained at the forefront, with private equity parties focusing on allocation of risks that would have been considered unexpected before 2020.

II. Trends in the Private Equity Market

ESG considerations

Private equity sponsors are facing a gathering set of ESG pressures from the regulatory and investor realms to address ESG issues in the economy. The EU has led the way on regulatory pressure, with one standout step being its Taxonomy Regulation, which seeks to establish a common sustainability language. In the U.S., the Securities and Exchange Commission has made several public statements highlighting the importance of accurate and robust ESG-related disclosure. With this increased regulation has come downward pressure on both public companies and private equity sponsors to prove their ESG credentials, driving a thirst for reliable ESG data. Pressures from the ground up have come from changes in shareholder and consumer ESG demands, employee expectations and popular attitudes.

Not least as a matter of competition, private equity firms are seeing the value in aligning their investments with prevailing sentiments on ESG issues. Recent surveys have suggested that a significant proportion of limited partners ("LPs") now expect a strong ESG policy to lead to greater long-term returns, and emerging analyses support that expectation. Another developing trend is the linking of some performance-related elements of return to ESG-goal achievement, a concept proving more acceptable in Europe.

COVID-related contract terms

In last year's edition of this chapter, we highlighted a trend in the spring of 2020 of buyers attempting to terminate or renegotiate pre-pandemic transactions that had yet to close. As a result, provisions in acquisition agreements regarding the buyer's obligation to close the transaction came under renewed scrutiny. In the year since, carveouts from the definition of a material adverse effect ("MAE") for the effects of pandemics and other health crises have become routine. At the same time, the Delaware courts have emphasised that short-term COVID-related declines in target businesses, even if severe, do not qualify as an MAE if their long-term effect is minimal, and that other, already common carveouts in the MAE definition might capture the effects of a pandemic-related slowdown.

Sellers have also begun insisting on contractual language in the interim operating covenant to allow them to take extraordinary action in response to extraordinary events. This language has proven critical for sellers in light of the Delaware court's ruling that authorisation for such action is not implicit in the typical operating covenant as traditionally drafted. Notably, not all jurisdictions have interpreted the covenant the same way. An Ontario court held that the operating covenant should be analysed contextually and that a seller's actions in response to the pandemic did not violate its obligations under the covenant.

SPACs

The strong growth in global and U.S. equity capital markets since the spring of 2020 has been led by the unprecedented boom in IPOs for special purpose acquisition companies ("SPACs"). A record 248 SPACs went public in 2020, raising $83 billion; both those figures were easily surpassed in 2021 by the end of the first quarter. The SPAC surge has predominantly been a U.S.-based trend, though the eye-catching economics of SPACs have begun attracting significant interest in other regions. The UK government-initiated review of its listing regime recommended this year that the existing regulatory barrier to SPACs be lifted, albeit simultaneously with ensuring sufficient investor protections for those engaging in SPAC investment. This recommendation has been endorsed by the UK government and a consultation is currently underway.

Mergers with SPACs provide an alternative path for private companies to access public markets, giving them price certainty and a less complicated process than an IPO. As such, these "deSPAC transactions" constitute a fourth exit strategy for private equity sponsors, adding to the traditional paths of a portfolio company sale to a corporate buyer, sale to another private equity firm, or IPO. At the same time, though, with over 400 SPACs in the market searching for target companies, deSPACs may make for competition for private equity firms seeking target assets.

Recognising an opportunity in the SPAC market, some prominent private equity firms have taken to launching their own SPAC vehicles. This strategy is not without its challenges, however, as fund LPs may resent losing acquisition opportunities to the sponsor's SPAC. Transactions in which a sponsor directs its portfolio company to a merger with its own SPAC also raise questions of conflict of interest.

Increase in Foreign Direct Investment ("FDI") controls

A number of jurisdictions introduced FDI controls for the first time in 2020, and several more enhanced those FDI regimes that were already in place. This trend has continued in 2021, with the EU seeking to coordinate Member States with the FDI screening framework it put in place at the end of 2020, having advised its members to use their existing FDI controls to their fullest. Also notable is the UK's introduction of the National Security and Investment Act 2021 in April, which, although not fully implemented until the end of this year, unusually has retroactive effect in that relevant transactions that closed any time after November 12, 2020 may be called in for national security assessment. As with many other new FDI controls, these are not limited to the traditional transactions for national defence infrastructure assets, but extend to the finance, healthcare, infrastructure, transport, media, agriculture and technology industries sectors.

The increasing number and strength of these regimes will necessarily weigh into sponsors' due diligence into the feasibility of affected transactions and will require negotiation around the allocation of closing risk in transaction documentation where mandatory governmental approvals apply.

Dividend recapitalisations

Dividend recap activity has mirrored the private equity M&A cycle of 2020 and has continued its robust rebound in volume well into 2021. Sponsors almost entirely put plans for leveraged loans and high-yield bond offerings on hold in the first half of 2020, opting instead to make sure that their portfolio companies' balance sheets were strong enough to survive an economic drought. As the economic outlook improved, sponsors quickly revived their plans for dividend recaps, helped along by lenders and credit investors eager to make these loans in the prevailing low-interest-rate environment. Although the pace of dividend recaps would be expected to fall off as the M&A market revives, this has yet to happen through the first half of 2021.

It is worth noting, though, that in the U.S., some Congressional Democrats are taking a sceptical view of dividend recaps, viewing them as a tactic by sponsors to pile debt on portfolio companies to funnel payments to themselves. One proposed piece of legislation would, among other proposed changes to the private equity industry, prohibit sponsors from collecting dividends for two years after acquiring a target company.

W&I market

With the decline in transaction volume at the start of the COVID-19 outbreak and new entrants into the market, the warranty and indemnity (W&I) insurance market became more competitive with decreased premiums and broader coverage being offered by underwriters. The broad-brush COVID-19 exclusions initially applied in W&I policies became more refined as insurers looked more closely at the actual impact on targets' businesses. The general exclusions traditionally included in policies as a matter of course were also reconsidered, leading to a narrower set of standard exclusions with focus on specific areas of concern. As deal volume rebounded in 2020, the market remained competitive and innovative, albeit more discerning, with premiums increasing in line with demand.

W&I insurance products continued to evolve in 2021, with additional risks and alternative applications being considered, such as the use of such policies in secondary transactions. Other innovations include an increase in the use of synthetic warranty deeds, given by insurers based on buy-side due diligence, which can be useful in distressed deals and a possible option in auctions. This trend can be expected to continue as furlough and other financial-support schemes come to an end later this year.

III. Outlook

Private equity activity levels have returned from the spring 2020 low to levels last seen in 2007. As more populations are vaccinated, pent-up demand works its way through the global economy and robust private equity activity can be expected to continue through 2021. LPs are increasingly signalling the influence of sustainability and diversity considerations, which sponsors must take into account when making investment decisions. With fundraising continuing to show strength, the challenge for the private equity industry in 2021 and beyond may be more about navigating uncertain socio-political than economic terrain.

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Dechert has been at the forefront of advising private equity firms for 35+ years. With more than 300 PE and private investment clients, we have unique insights into how the industry has evolved and where it is going next. Our globally integrated team of more than 250 private equity lawyers is based in major fund and investment jurisdictions throughout the United States, Europe, Asia and the Middle East. We deliver the reach, experience and creativity to support private equity firms at every stage, helping them find solutions to achieve the best possible returns.

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


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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 consistent theme is that we have a far more seller-friendly approach in the UK.

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, including where a transaction may be caught by the new national security and investment bill regime due to come into force in 2021, which will permit the UK Government to review (and potentially prevent) any transaction that involves a "national security interest"). 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 Material Adverse Change (MAC) condition. This essentially remained the case during the 2020/21 pandemic, on the basis that the pandemic was already subsisting whilst the transaction documents were being negotiated. 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 that 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.

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" that 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.

Management Incentives

A post-script on 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 that 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 known as "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.

Conclusion

All of the aforementioned 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.

Two countries divided by a common language – indeed!

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"Having a large amount of leverage is like driving a car with a dagger on the steering wheel pointed at your heart. If you do that, you will be a better driver. There will be fewer accidents but, when they happen, they will be fatal." **Warren Buffett**

Introduction

The last 18 months have seen massive reductions in both revenue and cashflow for many businesses. As a result, financial sponsors ('**Sponsors**') have watched with growing concern, fearing certain of their struggling and highly leveraged portfolio companies are heading inexorably into the sort of 'accident' Warren Buffett described.

However, the proliferation of covenant light ('**cov-lite**') debt packages and the absence of ongoing performance metrics in credit documentation may mean that Sponsors have a stronger hand when dealing with lenders in distress scenarios than headlines regarding market conditions might suggest. The continued wall of money across the deep high-yield capital markets and syndicated and alternative lending markets is stacked in favour of equity Sponsors, many of whom have become very adept at running competitive debt processes.

This chapter will explore some of the options available to Sponsors that are considering the adoption of defensive strategies in the face of lender-led distressed approaches.

Identifying the Distress

Typically, restructuring discussions will begin shortly after a waiver is requested from a portfolio company's lenders in relation to a default under that company's credit documentation, although there can be material benefit to starting those discussions earlier, depending on circumstances and the relationships involved. Indeed, discussions often begin as soon as a covenant or other default is anticipated owing to macro events or a softening of performance.

Given the massive growth in the use of cov-lite documents, there has been a general erosion of the 'early warning systems' traditional debt documentation included. By way of illustration, pre-2008 syndicated debt would typically include four performance triggers (which would customarily include covenants on leverage ratio, interest cover, debt service cover and capex); by contrast, a cov-lite facility would include only a 'springer' covenant applicable to the revolving credit facility and which operates more as a clean down than a traditional financial covenant. Alternative lending deals usually have a single leverage covenant, but increasingly with significant headroom and generous add-backs and look-forward *pro forma* adjustments for (amongst other things) internal operational restructurings and cost-saving projects, giving Sponsors significant release valves in times of distress. The outbreak of COVID-19 has further diluted the applicability of covenants (at least in the short term). Faced with the unprecedented impact on global economic activity in Q1 2020, lenders were often willing to provide borrowers with covenant holidays, provided debtor groups could adequately show that their business' underperformance was attributable to the impact of the pandemic. Given that this was usually relatively easy to do, even companies who are usually subject to financial covenants under their existing debt documents have operated for the last 12 months, without being subject to the 'early warning system' created by the covenant testing regime.

As a result, lenders are being brought to the table later and Sponsors and their portfolio companies are likely to have significantly more preparation time to appraise and improve their negotiating position before engaging with lenders. Good early analysis and strategic advice pays dividends in executing a successful defensive strategy.

In the absence of substantive performance triggers, cash flow and liquidity are likely to be the key drivers in assessing the imminence of default. In particular, the Sponsor and the board of the portfolio company will need to consider (among other matters): (i) whether interest payments can be made on time; (ii) how accurately cash flow can be mapped against near-term liabilities; and (iii) whether there are any short-term financing options permitted under the credit documentation. Prior to COVID-19, the most common routes to increased liquidity included factoring arrangements, sale and leaseback schemes or the execution of an asset sale; however, in 2020 and 2021, borrower groups across Europe have also been able to improve their cashflow positions by utilising government-funded financial support schemes.

Duties and Conflicts

Where insolvency is a real possibility, both the Sponsor and the board of the portfolio company will need to be mindful of the shift in directors' duties toward value preservation for creditors. This can place Sponsor-appointed directors in a particularly difficult position when it comes to conflicts of interest; while it is usually permissible for a director to vote on matters in respect of which they have an interest if it is declared, the dynamic opens up an unhelpful avenue of attack for lenders. This risk can be partially mitigated by the Sponsor through the adoption of stringent governance protocols and, when appropriate, arranging for the Sponsor and the portfolio company to retain separate and independent counsel.

In a similar vein, the Sponsor will need to be mindful of the risks of shadow directorship and the possibility of transactions entered into during this period being reviewable in the event of an insolvency.

What Are the Sponsor's Aims?

Assuming that distress has been identified and a liquidity or solvency default is expected to be triggered under the credit documentation, a Sponsor must first ask itself what it ultimately intends to achieve before seeking to implement a defensive strategy. The answer will be dependent on a number of factors, including: (i) the performance of the portfolio company to date; (ii) whether it is realistic to expect future returns from the investment if it is retained; and (iii) the life cycle of the fund that holds the company and, in particular, whether that fund is able to provide additional liquidity and where in the capital structure such funding can be advanced. Whether there have been previous injections of further funding by the Sponsor is particularly relevant in this context, as limited partners in the funds will be concerned as to whether following their money is still the right thing to do, or whether it is time to cut losses. Questions will inevitably arise around the overall sector performance and its future, which may be particularly difficult to answer in this era of paradigm shift, as well as the management team and whether changes need to be made to weather the storm and get back on track.

One other significant consideration will be whether the Sponsor is currently fundraising: if the Sponsor is forced to realise an impairment during a fundraising cycle this will have a detrimental impact on returns and, potentially, the Sponsor's reputation. For Sponsors that are perennially fundraising, this concern may be particularly acute. In these circumstances, the Sponsor may decide to look hard at ways of retaining an asset to avoid disrupting the fundraising process. General reputational and track record considerations will always apply.

This assessment may be done in parallel with the review of the Sponsor's negotiating position under the credit documentation or otherwise (see *Passive and Active Levers*, below) so that the Sponsor arrives at a true view of risk and reward. It is not uncommon for Sponsors that learn they have more negotiating leverage or hold-out value than previously thought to suddenly see a distressed asset in a more favourable light. Similarly, where a Sponsor lacks strategic levers to prevent a lender-led restructuring, it may decide that a swift and fully consensual exit is the best way forward, even for assets which might otherwise remain attractive. If the fund or funds are otherwise performing well and have completed a high number of successful exits, an orderly handover of the keys or an exit to a distressed specialist investor may be a more logical and better outcome than a 'Hail Mary' play to save the business in current ownership.

Passive and Active Levers

At the same time as considering how attractive the retention of the relevant portfolio company is in the abstract, a Sponsor should consider what leverage it has by virtue of the facts and circumstances intrinsic to the situation (passive levers), and the ways in which they can proactively influence the dynamic in their favour (active levers).

Passive levers

Examples of structural or 'passive' advantages the Sponsor might enjoy include whether or not the lender syndicate is highly concentrated (which yields efficiencies in terms of the number of counterparties with whom active engagement is needed, while ceding some negotiating power), how much of the debt stack is underwater and whether the lenders have divergent objectives (e.g., distressed investors who have invested at well below par will have different imperatives to traditional bank lenders who have held the debt from the outset). An increasingly important – and potentially complicating – lender will be the government itself, due to the proliferation of financial support schemes. The government is likely to be influenced by policy just as much as profit, so is likely to look closely at factors such as governance costs and ESG. The company will therefore have additional restrictions to comply with, and a more complicated stakeholder to appease, on the road to recovery. Fully understanding which lenders hold what instruments is crucial in finding a way forward – for example: (i) will certain lenders have a different perspective due to cross holdings in different classes of capital in the structure; and (ii) are all lenders capable of holding equity instruments if that is agreed as part of a broader restructuring solution?

Other (non-exhaustive) examples of structural advantages that may be enjoyed by Sponsors include:

(i) the absence of a single point of enforcement for lenders, with the attendant complexity of enforcement that this entails;

(ii) the requirement that the lenders enforce in 'creditor-unfriendly' jurisdictions;

(iii) actively negotiating with more junior lenders in the capital structure to force a deal on senior lenders, by using new legislative restructuring procedures (such as the Restructuring Plan in the UK), which incorporates a cross-class cram down mechanism; and

(iv) the identity of the security agent.

Active levers

Active levers are the means through which Sponsors and portfolio companies can directly influence the negotiating dynamic. While some of these tactics could be considered aggressive, it will often not be necessary to actually 'use' an active lever; the mere fact that it is available as an option to the Sponsor can significantly bolster its negotiating position.

Examples of 'active' levers include (non-exhaustively):

(i) actively preventing the occurrence of an event of default (through EBITDA add-backs, *pro forma* adjustments or equity cures);

(ii) the policing of transfers into and out of the lending syndicate; and

(iii) transfers of value away from existing lenders where this is permitted due to gaps in the credit documentation and raising financing against those assets.

Sponsors should be mindful of reputational risk when considering active levers: lenders may be engaged across the Sponsor's portfolio and an overly aggressive approach may make it challenging, or more expensive, to borrow money in future. That said, the Sponsor will also wish to avoid signalling to loan-to-own investors that their portfolio is an 'easy target'.

Having established its view of the distressed portfolio company and the tools at its disposal (both active and passive), a Sponsor should now be well equipped to turn its attention to engaging with the lender group.

Conclusion

As markets begin to recover from COVID-19 and its effects, there will likely be many businesses who struggle with the new normal. The ubiquity of cov-lite debt packages, financial support packages, and new legislative restructuring regimes may present Sponsors with the opportunity to retain assets that they might previously have been expected to exit consensually in distress scenarios. In other words, the general position of Sponsors looks at least as good, if not better, than it did in the financial crisis after the debt binge that preceded that. Foremost among the benefits yielded by the cov-lite regime in this context is, perhaps, the time afforded to the Sponsor to prepare for its engagement with the lender group. Early preparation with specialist restructuring counsel is crucial in assisting with the development of a coherent strategy that provides the best possible chance of securing a positive outcome.

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Sidley has an extensive Private Equity practice with lawyers around the world focused on advising our private equity clients, including general buyout funds, specialist funds in sectors like infrastructure, real estate, energy, financial services, insurance and healthcare, sovereign wealth-funds, pension funds, family offices and other limited partners.

Our private equity lawyers possess deep experience across the broad spectrum of private equity transactions, from multibillion-dollar leveraged buyouts (LBOs), platform buy-and-builds, consortium deals and co-investments, large-scale restructurings and distressed investing, to growth equity investments in premium middle markets companies. The firm has built a practice with a committed multi-disciplinary one team with one objective – to help the client meet theirs. Corporate, debt, restructuring, tax and other private equity specialists work seemly with a deep bench of specialist employment, wide variety of regulatory, compliance and industry operational legal specialists.

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De-SPAC Transactions in Europe

Kirkland & Ellis

Dr. Sebastian Häfele

1. Introduction

Special purpose acquisition companies ("SPACs") experienced a roaring revival in 2020 and have become a mainstream "fast track" alternative to a "traditional" initial public offering ("IPO") for a listing on a stock exchange. Particularly in the United States, SPACs became very popular over the past 18 months and around 250 SPACs raised more than half of the stock market capital in the United States in 2020. Moreover, in the first quarter of 2021, around 300 SPACs raised more than USD 90 billion.

Meanwhile, this SPAC boom has also reached Europe. The Frankfurt Stock Exchange saw the first SPAC IPO in a long time, when the Lakestar SPAC I was listed in February 2021 with a volume of EUR 275 million. Several additional SPACs announced their IPOs on the Frankfurt Stock Exchange and Euronext Amsterdam in the first half of 2021. The Netherlands in particular provides for a very competitive environment for SPACs and De-SPACing transactions due to favourable legal conditions of Dutch law.

Despite the record-breaking numbers in the first quarter of 2021, the SPAC market has cooled off in recent months; only 13 new SPACs were listed in the United States in April, and in May there were barely any more. Also, potential investors were reluctant with their investments in De-SPACing transactions, as the share prices of several SPAC targets had fallen below the initial share price and certain investments have decreased in value.

Despite such dip in the market, a SPAC is still one of the hottest investment vehicles in the market. SPACs offer plenty of opportunities for investors and companies alike. Yet there are also risks and it is important to understand the particularities of this alternative to the traditional IPO. This chapter will give background knowledge, explain technicalities and give an outlook on the future of SPACs and De-SPACing transactions.

2. The SPAC Model

The SPAC model works as follows: an "empty" shell company without an operating business goes public and raises capital from (mostly exclusively) institutional investors in the course of the IPO. The capital raised through the IPO – with the exception of funds required for ongoing business operations of the SPAC (approximately 5%) – is deposited in a trust account administrated by a third-party trustee and is only available for limited purposes, predominantly for funding the Business Combination with an operating entity. In the IPO, the SPAC issues so-called "units" that consist of one share (usually offered for USD 10) and a warrant (or a fraction of a warrant) that gives the right to subscribe to a certain number of shares in the SPAC at a fixed price. Warrants are issued with a premium to the stock price (the exercise price is usually 15% above the IPO share price) and are separately tradeable. The subscription right granted under the warrants is usually only exercisable when the Business Combination is implemented or a minimum period has expired (e.g. one year after the SPAC IPO). The warrants often cap the upside and can be redeemed by the post-closing company if the trading price exceeds a certain threshold (e.g. USD 18 per share).

The SPAC has a two-year lifespan in which the SPAC must implement a Business Combination with an operating company, thereby taking such target entity public (so-called Business Combination or De-SPAC transaction). The SPAC shareholders may extend the 24-month period for the SPAC to implement the Business Combination by a majority vote. Typically, such extension vote requires a majority of 65%. In case no suitable target is found within the two-year period (or as extended), the SPAC entity will be liquidated and the deposited capital will be returned to the SPAC shareholders.

3. The De-SPAC Process

a) The De-SPACing transaction

The De-SPACing transaction "simplifies" the process of taking an operating company public since such operating company does not have to go through the traditional and lengthy IPO process. A fast-track De-SPAC process can be completed within three to five months compared with the traditional IPO process, which takes approximately nine to 12 months.

The steps that are required to be implemented in order to effectuate the Business Combination are set forth in the respective Business Combination agreement, which is executed between, among others, the SPAC and the target entity. The Business Combination is usually effected through a series of mergers, equity contributions and exchanges; this, however, depends on the jurisdictions in which the entities involved in the Business Combination are incorporated.

After signing the Business Combination agreement and prior to implementation of the Business Combination, an extraordinary general meeting of the SPAC will be held in which the SPAC shareholders vote on the approval of the Business Combination. In connection with the shareholder vote, the SPAC shareholders may elect to have their shares redeemed in which case they will not participate in the Business Combination with the operating company and receive the initial IPO purchase price plus interest thereon for each share so redeemed. Therefore, the ultimate amount of proceeds available for the target from the SPAC trust account is not known until shortly before closing. To provide certainty with respect to the available cash proceeds to be received from the SPAC, target entities regularly negotiate a minimum cash condition to ensure that the SPAC has an amount available at closing that is sufficient for the needs of the target and can be used for further growth.

After implementation of the De-SPAC transaction, SPAC investors and former owners of the company – as well as possible PIPE investors – jointly hold shares in a then listed holding company of the operating company.

b) Structuring of the De-SPACing transaction

The Business Combination with the target by the SPAC itself can take any transaction form (e.g. company acquisition in the form of share or asset deals, mergers, corporate actions, contributions). After the successful Business Combination with the target, the sponsor of the SPAC receives shares of typically 20% of the SPAC volume at a significantly lower price than the investors (so-called Sponsor Promote), as a form of compensation. In a German to U.S. De-SPAC Business Combination, a Dutch holding structure is usually the preferred option as Dutch corporate law is flexible and, in particular, allows unrestricted share redemption and issue of warrants. The warrants and shares can be traded separately, on both the Frankfurt and Amsterdam stock exchanges. In addition, Dutch law allows for dual-tax residency. The entity can be incorporated in the Netherlands but have the place of management in another jurisdiction. This means that the management of the target – which usually also becomes the management of the holding company – does not have to move, but can remain in the foreign country with the effect that the Dutch holding company is taxable in such foreign country.

In a German to U.S. De-SPAC transaction with a U.S. listed SPAC, the SPAC is usually merged into a subsidiary of the Dutch holding company (Dutch TopCo). The SPAC shareholders will receive shares in the Dutch TopCo and the shares of the SPAC are cancelled and cease to exist. Subsequently, the shares in the German target are contributed into the Dutch TopCo against issuance of shares in the Dutch TopCo. In the course of the Business Combination, the SPAC securities will be delisted from the specific U.S. stock exchange, the SPAC will be deregistered and the Dutch TopCo will be listed on the same U.S. exchange where the SPAC shares were listed. In case the Dutch TopCo qualifies as a "foreign private issuer" under U.S. securities laws, it is as such subject to different U.S. securities laws than domestic U.S. issuers, e.g. the disclosure regulations applying to a "foreign private issuer" are less strict than for U.S. entities and less information needs to be filed with the United States Securities Exchange Commission.

4. Robust PIPE Market as a Decisive Factor for a Successful De-SPAC Transaction

Concurrently with the signing of the Business Combination agreement, the SPAC usually looks for investors, which invest in the SPAC through a private placement of shares once the Business Combination is completed (i.e., private investment in public equity, so-called "PIPE Investment"). The PIPE Investment shall provide additional cash to the SPAC in order to fund the growth of the acquired business and also compensate the cash out for the redeemed shares. The PIPE not only provides for additional equity for the target but also validates the valuation of the target company and increases the liquidity of the shares. In the first half of 2021, more than 150 SPACs have merged with target entities and the vast majority (approximately 90%) of such mergers were combined with a PIPE offering. In March and April 2021, PIPE investors were reluctant to participate in Business Combinations and commitments from the PIPE market were not available for target entities in De-SPAC transactions. As a consequence of the decline in PIPE commitments in March and April 2021, De-SPACing transactions became more difficult, and several such transactions were postponed. In addition, certain target valuations negotiated prior to such time were re-negotiated and adjusted.

In a PIPE investment, institutional PIPE investors subscribe for a certain number of shares in the listed entity in consideration for a subscription amount (whereby the shares will be issued at the SPAC IPO price) in connection with the Business Combination. In case of such PIPE investment, the respective investors sign the subscription agreements and thereby commit to the investment simultaneously with signing of the Business Combination agreement and, at closing of the Business Combination, will fund and receive the shares in the listed company. The proceeds received by the target from the PIPE investors are usually required for the operational business of the target. Therefore, a robust PIPE market can be decisive for the success of a De-SPAC transaction and is a key driver for the incredible pace of De-SPAC transactions that we have seen since the beginning of 2020.

The marketing process to potential PIPE investors usually starts shortly after the SPAC and the target entity have signed the letter of intent/term sheet in relation to the envisaged Business Combination. Once the PIPE investors are wall-crossed and agree to confidentiality and non-trading, they receive an investor presentation and will start conducting their own due diligence in order to assess the attractiveness of the potential investment. The evaluation conducted by the PIPE investors validates the valuation of the target agreed between the SPAC and the target *vis-à-vis* the public shareholders. From the start of 2021 until mid-June, approximately USD 46.8 billion has been raised in PIPE transactions connected to De-SPAC transactions, compared with approximately USD 25.1 billion in 2020.

A sponsor may also agree to enter into forward purchase agreements and commit to purchase additional securities at the closing of the Business Combination in order to make up for potential redemptions or supplement the PIPE investments. This gives the target additional certainty to have a sufficient amount of cash available at closing.

5. A Glance into the Future

A De-SPAC transaction can be attractive and offer a unique opportunity for growth-oriented companies that already have an established business model (e.g. late stage venture capital entities) and need capital for further growth. De-SPAC transactions enable such companies to raise a significant amount of capital through the Business Combination with the SPAC. A De-SPAC has the advantage of the target entity pre-agreeing on the valuation with the SPAC and having clear visibility on the funds to be received in connection with the Business Combination. Different from traditional IPO scenarios, the target entities are not exposed to market fluctuations and the uncertainties connected with the pricing in such traditional IPO processes.

De-SPAC transactions have proven to be a suitable route to achieve a listing of an entity on the stock market and will be a permanent alternative to traditional IPO processes, not only for late-stage venture capital firms but also for established operating entities. The success of a De-SPAC transaction, in most cases, depends on an existing market of PIPE investments, which play an important role in the potential Business Combination. The availability of PIPE proceeds for the target entity often determines the pace and feasibility of a successful De-SPACing process. Therefore, PIPE investors will continue to play an essential role for targets to have certainty on the proceeds to be received in connection with the Business Combination and PIPE investors will also be important for the public shareholder base as an "instrument" to validate the valuation of the target entity.

Attractive target entities that offer market opportunities and create upside potential in relation to the price performance, which is a key driver for PIPE commitments, will be suitable targets for PIPE investors and, therefore, for successful De-SPAC transactions in the future.

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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?

The Australian private equity market continues to be affected by the economic impact of the COVID-19 pandemic; however, there was evidence of resurgence in the market during 2020.

The Australian Investment Council (AIC) reported the growth of Assets Under Management (AUM), reaching A$37 billion as of June 2020, while private equity fundraising in Australia increased on the previous year, with a total of A$4.3 billion secured via seven funds, up 2.7 times on the amount of capital raised in 2019. On the investment side, while there were 20% fewer private equity-backed deals in 2020 compared with 2019, the average deal size increased. The total deal value for the year declined slightly by 12%. Consumer discretionary, financial and insurance services and raw materials and natural resources were key sectors of investment.

The early stages of the COVID-19 pandemic induced a slowdown in exit activity, which played a role in maintaining high AUM levels. Exit activity returned in Q4 2020, with 17 exits valued at a combined A$3.5 billion.

The Australian private equity buy-side activity is projected to increase in 2021 due to the accumulation of "dry powder", stability of the virus and economic conditions, and a favourable debt market. In particular, there has been a sharp rise in leveraged buy-out (LBO) deals in Australia, as private equity sponsors have been utilising credit opportunities that arise from competitive tension among lenders to achieve desired rates of return for asset opportunities in sectors where competition remains fierce. For example, in March 2021, KKR launched an LBO buy-out to support its acquisition of a majority stake in wealth manager Colonial First State.

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

Significant factors encouraging Australian private equity transactions in normal circumstances include:

- domestic bank interest rates staying at historic lows; and
- attractions of Australia for inbound investment through:
  - a lower Australian dollar forex rate compared to previous years;
  - perceptions of Australia as a "safe haven" destination compared to volatility overseas; and
  - the impact of government initiatives like the Biomedical Translation Fund and the National Innovation and Science Agenda (NISA).

Significant factors inhibiting specifically Australian private equity transactions include:

- a thinner market for deals and domestic capital; and
- a less favourable taxation regime for private equity compared to markets such as the US and UK.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

In respect of existing investments, there might clearly be a longer timescale to exit than had been envisaged prior to the pandemic. It has become a commonplace observation that Australian private equity funds are sitting upon a mountain of "dry powder" (i.e. capital yet to be deployed by investment in portfolio companies), reported by the AIC to be over A$14 billion in 2020; therefore, there will be capital available for new investment by funds confident enough to act. It would seem highly likely that new opportunities will transpire in the technology sector, for instance.

On 1 July 2021, changes to the Business Innovation and Investment Program (BIIP) and the Complying Investment Framework (CIF) will take effect to support Australia's post COVID-19 economic recovery. The key changes include:

- the subclass 188 (Investor Stream) visa (Investor Visa) investment threshold will increase from A$1.5 million to A$2.5 million; and
- the new CIF breakdown, which is:
  (i) 20% venture capital and private growth equity funds, up from a previous 10%;
  (ii) 30% funds investing in emerging companies; and
  (iii) 50% in balancing investments, down from a previous 60%.

The purpose of these changes is to increase the amount of foreign investment through these visa programmes and to shift the focus of investment towards venture capital and private growth equity.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

Private equity is a comparatively undeveloped segment in the Australian M&A market relative to the UK and US, for instance, so we would not expect to see private equity-style transactions generally gaining traction with a broader range of investors and markedly different deal terms being offered than for those firms practising across other jurisdictions. That being said, Australian Superannuation funds continue to transform through increased direct investment activity, particularly during the second half of 2020. For example, in December 2020, AustralianSuper submitted a non-binding proposal by way of a scheme of arrangement to acquire all shares in Infratil Limited.

2 Structuring Matters

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

Private equity funds can take a combination of equity and debt interests in targets, structured by any combination of:

- convertible subordinated loans. Unsecured loans subordinated to senior and mezzanine debt (e.g. acquisition debt) potentially convertible into equity immediately prior to exit;
- preference equity. Preference shares offering a coupon during the term of investment but potentially *pari passu* with ordinary shares upon exit; and/or
- ordinary shares. Potentially *pari passu* with management interests.

Warrants can also be taken by private equity funds, i.e. options over unissued shares, potentially for greater control on realisation of downside risks, e.g. unsatisfactory management performance/covenant breaches in special/distressed situations.

2.2 What are the main drivers for these acquisition structures?

Relative composition of debt/equity interests depends on factors including:

- requirements of third-party financiers, e.g. for subordination of private equity fund debt interests;
- requirements of private equity fund investors, e.g. as to balance of interim income (favouring debt/preference shares) and final capital returns (favouring equity);
- tax planning for: (a) private equity investors; (b) portfolio companies, e.g. deductibility of debt interest payments; and (c) management, e.g. meeting criteria for equity tax incentives;
- prospective cash-flows, i.e. the company's ability to service existing and additional debt interest; and
- deals with incumbent/incoming management, e.g. real equity incentives.

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

Institutional investors might typically participate by acquiring bid vehicle ordinary voting shares. Management might typically be offered ordinary, but non-voting, bid vehicle shares, subject to amplification of returns by "ratchet" (see the response to question 2.5) with transfer restrictions/drag-along rights for institutional investors on exit.

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

The lack of control involved in a minority investment means that structuring must be very carefully considered to ensure either that the private equity investor has sufficient veto rights and other protections as regards how the investee is managed, and also to ensure that the private equity investor can both avoid value destroying dilution of its ownership and be able to obtain a swift exit from the investment on fair terms, should the investor be unhappy with the direction of the investee company. Good legal advice at the "heads of agreement/terms sheet" stage is usually critical to ensuring that the appropriate structures can be agreed in detail at an early stage, as introducing such protections later in the process will usually be met with stiff resistance.

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 is between 5% and 15%. Vesting can depend on the anticipated time of exit, whether a non-recourse loan has funded the subscription's proceeds and the structure of the management's equity.

Vesting and compulsory acquisition provisions depend on the management interest's legal structure. Where management take actual shares, vesting and compulsory acquisition provisions will be familiar from other jurisdictions, including:

- vesting provisions whereby management's equity interest is adjusted by "ratchet" referable to factors such as length of service and the company's financial performance relative to milestones/targets; and
- compulsory acquisition provisions upon management departure, alternating between:
  - bad-leaver – management interest acquired at cost/book value upon departure:
    - at own volition, e.g. prior to fixed date; or
    - on termination for cause/not meeting agreed performance; and
  - good-leaver – management interest acquired at fair market value upon departure:
    - at own volition, e.g. prior to fixed date; or
    - on faultless incapacity, e.g. long-term illness/termination without cause.

Alternatives to actual shares include:

- options over unissued shares at nominal/no strike price, vesting in actual shares on service/performance-based events (potentially according to "ratchet"); exit events; and/or "good leaver" departures; or
- phantom schemes – management receive a cash bonus of the amount their equity interest would have realised, subject to "ratchet", upon exit event or "good leaver"/"bad leaver" departure, being easier to operate as a simple debt obligation of the company, but possibly unpopular with management seeking a voting interest or equity tax incentive criteria being met.

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

Given the comparative smallness of the private equity market in Australia relative to the UK or the US, leaver provisions are less standardised than they are elsewhere.

In Australia, we would typically see "good leaver" treatment for an executive who leaves because of death, permanent disability or incapacity, or is otherwise agreed to be a good leaver. The typical consequence is the ability to sell shares at fair market value. We would typically see "bad leaver" designation for any executive that is not a "good leaver" (commonly one who leaves to take a better offer of employment before exit). The typical consequence is the compulsory acquisition of their shares at cost, unless the fair market value is lower.

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 and management will often enter into a shareholders' agreement governing their relationship and commonly dealing with:

- management constitutional issues:
  - quora for directors' and shareholders' meetings;
  - director removal/nomination rights for private equity investors; and
  - potential referral rights for votes from board to shareholders where not otherwise required by statute;
- management operational issues:
  - performance targets/milestones and impact on management incentive, e.g. equity "ratchet";
  - information rights over financial reports/performance against lending covenants; and
  - veto rights where not otherwise available under corporation law for:
    - dilutive issues of equity (alternatively pre-emption rights);
    - incurring (further) debts (depending upon existing negative pledges);
    - approving budgets/business plans;
    - approving M&A; and
    - approving dividends/distributions; and
- exits:
  - equity lock-ups prohibiting transfers by management/other investors outside:
    - permitted transfers (e.g. intra-group/declarations of trust);
    - transfers subject to good-leaver/bad-leaver mechanics; and
    - pre-emption rights/drag-along/tag-along exit rights.

Shareholders' agreements for proprietary (e.g. private) companies are private contracts and, unlike in the UK, their constitutions are not ordinarily a public document, so there is not normally confidentiality lost in duplicating shareholders' agreement provisions in the constitution, where appropriate.

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. It is not unusual to include in shareholders' agreements veto rights against any of the following: material M&A; commencing/defending litigation; related party transactions; incurring (additional) debt; changing the nature of the business; and/or adopting or changing business plans/strategy.

Private equity investors holding minority interests (but with over 25% voting rights) ordinarily have veto rights under the Corporations Act 2001 (Cth) (Corporations Act) over:

- modification/repeal of constitution;
- change to company name;
- change to legal classification, e.g. proprietary company becoming public;
- selective reduction of capital or buy-back of shares;
- giving financial assistance; and
- members' scheme of arrangement.

Statutory veto rights can be:

- negated by increased voting rights attached to majority shares in respect of any/some/all relevant votes; or
- increased by additional shareholders' agreement veto rights (see the response to question 3.3).

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?

(i) If the company is party, shareholders' agreement veto rights might not be effective in fettering the company's statutory powers if employed against the company rather than its shareholders, if the UK House of Lords' decision in *Russell v Northern Bank Development Corporation Ltd* is applied in Australia – the same applies if such veto rights appear in the constitution.

Russell v Northern Bank may be mitigated in any event by weighted voting rights (potentially varying by subject-matter) facilitating statutory majorities not being obtainable where minorities object, even without statutory veto rights.

(ii) Nominated directors are subject to the same statutory and common law fiduciary duties as other directors. At least while the company is solvent, they have to take into account its best interests, being the interests of all shareholders, not just those who nominate them.

The exercise of a board veto willed by a shareholder might not be in the interests of all shareholders and therefore in breach of that nominated director's fiduciary duties. This could be dealt with by provision in the shareholders' agreement/constitution permitting directors to refer veto matters to a shareholder meeting, where fiduciary duties do not apply. Nevertheless, such a right should be considered carefully to not become routine, and may entail potential shadow director liability for nominating 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?

There are no specific duties owed by private equity investors to minority shareholders (i.e. fiduciary duties do not apply). The same applies *vice versa*, save to the extent that duties are owed by management shareholders in their capacity as directors/officers.

That being said, private equity investors are subject to:

- certain contractual provisions in the constitution and/or a shareholder/s agreement (e.g. provision of financial information); and
- general statutory and common law protections (e.g. orders in respect of majority conduct deemed: contrary to the interests of shareholders as a whole; or oppressive to, unfairly prejudicial to, or unfairly prejudicial against, a shareholder or shareholders, whether in that capacity or in any other capacity).

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)?

(i) There is no general prohibition on shareholder agreements including non-domestic governing law and jurisdiction provisions.

(ii) Non-compete/non-solicitation provisions are subject to the same limitations as in ordinary commercial contracts, being potentially invalid under common law restraint of trade. To be enforceable, relevant provisions have to protect a legitimate business interest (e.g. private equity investor against departing management) with reasonable scope in terms of duration and geographical/business reach.

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?

Overseas investors should note that proprietary companies need at least one director who is ordinarily residing in Australia.

(i) Key potential risks/liabilities for nominee directors include:

- breach of statutory duties and common law fiduciary duties, with a wide variety of civil/criminal penalties and/or an obligation to compensate the company; and
- insolvent trading for board members when: the company incurs a debt and there are reasonable grounds for suspecting that the company is or would become insolvent; and the company is insolvent, or becomes insolvent by incurring that debt.

Statutory provisions also void mitigation of these risks by companies:

- exempting liabilities incurred by persons as officers;
- indemnifying persons for most liabilities incurred as officers; and
- payment of premiums for contracts insuring officers against many liabilities for wilful breach of duty or breach of some statutory duties.

(ii) Although investors would generally be protected by corporate limited liability and the "corporate veil", key potential risks/liabilities for investors that nominate directors to boards include "shadow director" responsibility for the liabilities described in (i) above, if the investor is deemed (amongst other things) to be a person "in accordance with whose instructions or wishes the directors of the corporation are accustomed to act". There are also exceptions to the "corporate veil", e.g. fraud.

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?

Nominated directors are *prima facie* required by statute (and potentially also by the constitution/shareholders' agreement) to notify other directors of material personal interests in matters relating to the affairs of companies due to either their:

(i) relationship with their appointor; or

(ii) position as directors of other portfolio companies, subject to exceptions.

Notice does not, of itself, discharge the statutory duty to exercise powers in good faith in the best interests of the corporation and common law fiduciary duties.

However, statutory disclosure for proprietary companies permits (subject to constitution):

(a) voting on matters relating to the interest;

(b) approving transactions that relate to the interest; and

(c) retaining transaction benefits.

The company may not (subject to constitution) avoid transactions merely because of a disclosed director's interest or an interest within the statutory exception to disclosure.

Statutory/common law duties might also be mitigated by constitutional/shareholders' agreement provisions accepting conflicts of interests represented by appointor shareholders/appointments to other portfolio company boards, provided directors' actions are otherwise consistent with company law. Non-statutory/constitutional internal management protocols can also regulate conflicts.

4 Transaction Terms: General

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

The major hurdles impacting the timetable for transactions in Australia include:

- Foreign Investment Review Board (FIRB) approval. Foreign private equity investors (and local private equity investors that have "foreign government investors" as limited partners) will often be required to seek foreign investment approval for their acquisitions. It is beyond the scope of this response to list all the circumstances in which notification might be made under the Foreign Acquisitions and Takeovers Act 1975 (Cth) (as amended) and the Foreign Acquisitions and Takeovers Regulation 2015 (Cth); nevertheless, the key changes to the FIRB regime effective 1 January 2021 are:
  - (a) the previously applicable A$0 threshold has been uplifted for foreign investments other than those with national security implications; and
  - (b) the FIRB application fee regime has changed, with fees becoming, on average, higher.
- Competition approval. There is no mandatory requirement to seek antitrust approval in Australia. At present,

most notifications request informal merger approval, with no formal timetable. If notified transactions are cleared, the Australian Competition & Consumer Commission (ACCC) provides a non-binding "letter of comfort" stating no present intention to oppose. The informal ACCC process has two stages. Initial review/"pre-assessment" considers whether transactions *prima facie* raise competition concerns and they are cleared where risk of competition issues is considered low. A significant proportion of notifications is pre-assessed quickly, often within two weeks of notification. A second in-depth public review follows for more contentious mergers, comprising:

(a) two to five weeks of market inquiries, with active scrutiny of information from competitors, suppliers and customers, and other interested persons;
(b) usually within six to 12 weeks, a decision not to oppose, or a statement of issues; and
(c) if there is a statement of issues, another round of market inquiries, which can take an additional six to 12 weeks, or potentially longer.

More recently, since 20 March 2020, the ACCC has granted 16 authorisations across a range of industries, allowing businesses to collaborate in response to the COVID-19 pandemic in circumstances that might previously have been subject to their regulatory supervision.

- Change of control consents. Australian Securities Exchange (ASX) listed companies are subject to continuous disclosure obligations and have an immediate *prima facie* obligation to disclose information (such as investment or acquisition by private equity investors) that a reasonable person would expect to have a material effect on the price or value of their securities.

  On 26 May 2020, the Federal Government introduced a temporary test, replacing the objective "reasonable person" test with a test of whether the entity knows or is reckless or negligent with respect to whether the information is price-sensitive. Under these modifications, companies will only attract civil liability if they knew or were reckless or negligent with respect to whether the information would, if it were generally available, have a material effect on the price or value of their securities. These provisions expired on 22 March 2021. The Federal Government introduced the Treasury Laws Amendment (2021 Measures No. 1) Bill 2021 (Cth) into Parliament on 17 February 2021, which seeks to make permanent the aforementioned changes to the "reasonable person" test, but the Bill has yet to be passed.

  Disclosure can be deferred for information concerning "an incomplete proposal or negotiation" where it is confidential; the ASX has not formed the view that it has ceased to be confidential and a reasonable person would not expect the information to be disclosed. Where a public-to-private bidder has made a firm decision to proceed, this is communicated to the target and announced to ASX immediately with offer terms. The public-to-private bidder must make the offer within two months. It typically takes three to four months to conclude the offer and implement compulsory acquisition.
- Financial assistance approval. If target group members will be providing security in respect of acquisition-related loans then this may require notification to the Australian Securities and Investments Commission (ASIC) and approval by shareholders under the "financial assistance" rules of the Corporations Act.

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

Given the more limited volume of Australian private equity transactions when compared with other jurisdictions, it is difficult to verify generalised trends in commercial terms.

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 comprise:

(1) Off-market takeovers. Most takeovers are off-market, being an offer to all security holders in a bid class (whether or not listed) for all those securities or a proportion of them, implemented either by contractual takeover offer/bid or court-approved scheme of arrangement:
   (i) takeover bids/offers: a bidder's compulsory acquisition is ultimately permitted if the bidder and associates, by the end of the offer period, have:
      - relevant interests in at least 90% (by number) of bid class securities (whether or not acquired under the bid); and
      - acquired at least 75% (by number) of securities that the bidder offered to acquire under the bid.

      The requirement for (broadly speaking) committed financing coupled with the uncertainty of meeting these thresholds and ultimately obtaining approval of financial assistance given by the target company in security for acquisition leverage tends to mitigate against contractual takeover offers/bids by private equity funds; or
   (ii) schemes of arrangement: acquisitions with consent of target security holders according to a court-approved procedure under Part 5.1 of the Corporations Act. The scheme must be approved by:
      - at least 75% by value; and (generally); and
      - bare majority in number of holders, of offer class securities present and voting in the scheme meeting. Unlike in the UK, the court has discretion to dispense with a majority headcount.

      Votes of the offeror and associates are usually excluded, which makes it difficult to execute schemes where private equity offerors already have target stakes. Schemes provide "all-or-nothing" certainty that, if approved, the offeror acquires all scheme class securities, but if not, acquires nothing at all, so external leverage need not be drawn.
(2) Market takeover bids: comprising acquisition of listed securities by contractual offer through the stock exchange, which must be for all bid class securities, unconditional and in cash. They are less flexible and less common than off-market takeovers, particularly for private equity offerors, but can prove significantly faster where possible.

Australia is less stringent than the UK in expectations of bid financing when offers are made, not requiring the equivalent of UK "cash confirmations". Nevertheless, both the Australian Takeovers Panel (Takeovers Panel) and the ASIC advocate that bidders have reasonable expectations at announcement that funding (even if subject to drawdown conditions or not formally documented) will be available once an offer becomes unconditional, otherwise the Takeovers Panel can declare "unacceptable circumstances".

However, the Federal Court recently departed from an objective test for bidders to avoid being "reckless" in breach of the Corporations Act and suggested bidders' boards are only "reckless" if:

- they are subjectively aware of a substantial risk that they will not meet funding obligations if a substantial proportion of offers are accepted; and
- having regard to known circumstances, they were not justified in taking it.

Legislative reform is likely to be required to harmonise the legal position with expectations of the ASIC, the Takeovers Panel and market participants.

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

Lock-up devices including "no shop", "no due diligence" or "no matching rights" obligations allow private equity investors to seek exclusivity protection in public acquisitions. Targets often pay break fees in recommended bids on transaction failure in circumstances such as withdrawal of target board recommendation. However, such protections are frequently subject to a "fiduciary-out" for the directors of the target. This relieves the directors of lock-up obligations (or aspects of them) that may be required in their directors' duties.

The Takeovers Panel can declare unacceptable circumstances if the size or structure of break fees pose a disproportionate disincentive to competitive bids or unduly coerce target security holders. It considers break fees of 1% or less of target equity value "generally not unacceptable" unless payment is subject to excessive/coercive triggers. "Naked no vote" break fees (i.e. payable where a bid is rejected by security holders even in the absence of competing proposals) can fall into this category.

It is possible, but less common, for targets to seek reverse break fees upon transaction failure in circumstances such as a bidder not obtaining regulatory consent for which it was responsible, or breaching pre-bid agreements. The Takeovers Panel's 1% "rule of thumb" does not apply to reverse break fees, giving more flexibility in pricing.

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?

(i) Private equity sellers in secondary buy-outs might ideally prefer "locked box" structures where a fixed price is agreed over the target's historic or special purpose financial statements. The seller then covenants against value leakage from the statement date to completion. This structure provides purchase price certainty and affords greater seller control over the process. However, this mechanism's acceptability has declined in a less buoyant market for secondary buy-outs.

(ii) Private equity buyers might prefer (and come under pressure from external financiers to require) traditional acquisition consideration structures such as "cash-free/debt-free" enterprise valuations subject to adjustment by completion accounts for a target's completion: (i) cash; (ii) net debt; and/or (iii) working capital (against expectation).

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

Private equity sellers typically try to minimise warranties/indemnities on secondary buy-outs to pursue "clean exits" distributing sale proceeds quickly to investors. Sellers often claim to be "passive investors" not sufficiently informed in day-to-day operation of the target to give business warranties, trying to restrict coverage to title to shares, capacity and authority.

Buyers in secondary buy-outs typically seek to resist such an approach, unless factored in to the consideration paid, and the final outcome will ultimately depend upon a range of factors and the competitive forces at work.

The seller's management team's position depends on whether they remain with the company. It will not necessarily make sense for the buyer to seek aggressive legal recourse against incumbent management of their new portfolio company, which mitigates the value of their warranties/indemnities. Management will often claim an inability in any event to resource substantial liability, trying to limit exposure to a low multiple of annual salary.

Buyers seeking substantive recourse from such sellers and management might initially be told to "bridge the gap" with warranty and indemnity insurance (see the response to question 6.4).

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 provide other covenants, undertakings and indemnities relating to conduct between signing and completion for the maintenance of the present conduct of target business and assistance with regulatory filings. Covenants could be extended to management, depending upon whether they remain with the target (i.e. some buyers might not consider them necessary for management transferring to them). Sellers might also have to stand behind taxation/environmental indemnities.

Non-compete/non-solicitation covenants might also be sought from both sellers and management, particularly seller non-solicitation where management remain with the target.

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 certainly available on both the buyer-side (against the buyer's losses upon acquisition) and seller-side (against the seller's liabilities to the buyer under contractual warranties and indemnities, which can leave the buyer taking credit risk on both the seller and insurer). It is not unusual for sellers, who wish to limit their exposure or avoid retentions in escrow, to suggest it.

As (generally) a bespoke non-standardised product, it is difficult to generalise as to typical policy terms, but: (i) excesses/policy limits (and therefore an element of co-insurance from the seller) are typical but quantum responds to transaction size/premium pricing. Typically, excesses are approximately 1% of the enterprise value and policy limits, which are tailored to each transaction, range from 20–70% of the enterprise value; and (ii) carve-outs/exclusions typically include:

- seller's fraud (excluded from buyer-side policies);

- matters known to the buyer at completion;
- consequential losses (e.g. lost profits); and
- environmental liabilities, unless specifically negotiated for inclusion.

Warranty and indemnity insurance in Australia typically costs 1–1.5% of the policy limit (including brokerage). Goods and services tax and stamp duty also apply.

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

To the extent that sellers are successful in limiting warranties/indemnities to title/capacity/authority (see the response to question 6.2), secondary buy-out acquirers should expect them to be uncapped or subject to a cap equal to the aggregate purchase price. The management team might try to cap their liability at the deductible/excess of applicable insurance or at a relatively low multiple of aggregate salaries.

Where a more expansive limitation regime applies, tax warranties and "fundamental warranties" are typically not subject to *de minimis*, may not be disclosed against, and have a limitation period between five and seven years.

For more general business warranties, limitations will be familiar from general corporate transactions, e.g.:

- *de minimis* thresholds on an individual and/or aggregate "basket" basis below which claims are inadmissible and above which claims are permitted either on a whole liability or excess-only basis; and
- time limitations normally being:
  - one audit cycle for general business warranties (e.g. 12–18 months from completion); and
  - longer for long-tail liabilities, e.g. environmental claims.

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)?

(i) Sellers typically resist customary requests on secondary buy-outs for purchase price retention in escrow pending term expiry of (most) warranties/indemnities, as escrow impedes distribution of sale proceeds from the seller fund to investors. Ultimately, presence/absence of escrow should therefore factor into valuation discussions.

(ii) Buyers in secondary buy-outs ideally seek escrow support for warranties/liabilities from both seller and management. Departing management can find it more difficult to argue against because they are not generally under the same pressure for rapid distribution of proceeds. In either case, secondary buy-out acquirers face suggestions that insurance is an appropriate substitute for escrow (see the response to question 6.4).

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 buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

(i) The debt financing package is often set out in a debt commitment letter and term sheet issued by the lead financier, replaceable with definitive financing documents if the private equity bid is successful.

(ii) Buyers' equity funding commitments are also often set out in commitment letters addressed to the target, which represent that the buyer has sufficient equity to meet purchase document obligations and commit to drawing down equity finance, subject to transaction conditions precedent. It is not unheard of in Australia for sellers to obtain specifically enforceable rights against buyers for an "equity cure" should debt financing not transpire, which are potentially subject to clean-up grace periods for buyers otherwise in default.

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 certainly possible (but not necessarily prevalent) in public-to-private transactions (see the response to question 5.2), but are less prevalent in 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?

A shareholders' agreement is terminated once a private equity investor conducts an IPO in respect of a portfolio company. Neither ASX Listing Rules nor market practice generally permit typical provisions in shareholder agreements including weighted voting rights and drag-along rights.

Furthermore, an IPO would likely impose lock-ups and escrow obligations on private equity sellers in respect of their retained shares in the listed company (see the response to question 7.2).

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

Historically, Australian sellers were not restrained from disposing their shareholding on IPO, but, recently, the Australian market has caught up with the US. In certain circumstances, once a company is admitted to listing on the ASX, it will be subject to an escrow (lock-up) period on certain shareholders, preventing that shareholder from disposing of the escrowed shares for a prescribed period.

In a common exception to "lock-up", they could sell down 25% of their shares in escrow if first half-yearly results had been published and the share price over 20 days was at least 20% higher than the IPO price.

Mandatory lock-up obligations may be imposed by the ASX on deemed "restricted securities", typically where the entity to be listed does not have a history of profits or is otherwise a speculative investment.

Lock-up obligations are designed to prevent early shareholders from selling their shares before the market has had the opportunity to fully value, through trading, the company's securities.

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 less common than trade sale exits in practice, dual-track exit processes are often cited as a means to try to drive competitive tension. In 2019, several potential, highly publicised IPO exits were withdrawn due to fading institutional investor interest and a complex regulatory environment for certain sectors. As a result, managers instead looked to trade sales as their dominant exit strategy. However, in contrast to previous years, in the second half of 2020, we saw a number of successful IPOs for private equity-backed businesses. While exit activity slowed in 2020, the back half of the year saw a number of successful IPOs for private equity-backed businesses, including Adore Beauty (Quadrant) and Universal Store (Five V Capital).

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 bank market represents a significant portion of the overall funding market in Australia, with traditional syndicated loans based on the forms agreed by the Asia Pacific Loan Market Association (APLMA) and the Loan Market Association (LMA).

Senior secured debt and mezzanine (or subordinated) debt are the most common sources of funding for private equity transactions in Australia, initial buy-out financing traditionally being limited to a few institutional bank lenders. However, unitranche and term loan B (TLB) financings have increasingly become a prominent feature in the Australian leveraged finance market.

High-yield bonds and securitisation structures have not generally been taken up, but bridge loans have occasionally been used to fund acquisitions, which might then be replaced by high-yield debt or retail debt securities, but this has not been typical.

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?

Like the UK but unlike much of the US, Australia has a statutory prohibition upon financial assistance given by a company to a person to acquire shares in that company or in its holding company. The prohibition typically pertains to the giving of security for acquisition debt without direct consideration. "Whitewash" shareholder approval either by a unanimous shareholder resolution or by a special resolution (at least 75%) passed by shareholders other than the buyer and its associates, is required to the extent financial assistance is materially prejudicial to the interests of the company or its shareholders or its ability to pay its creditors. If required, shareholder approval must be obtained and the ASIC notified thereof at least 14 days before the giving of the financial assistance.

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

The bank market still represents a significant portion of the overall funding market in Australia, primarily utilising traditional syndicated loans. However, recent times have seen a convergence of terms from Europe and the US with the increasing prevalence of international sponsors and the increasing prevalence of unitranche and TLB financing, and the associated first lien and second lien structures, in addition to the traditional mezzanine financing that remains commonplace.

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?

A key tax consideration for investors is classification of their investment as debt or equity to determine corporate tax treatment of returns (i.e. potentially a deductible interest expense or potentially a frankable dividend, respectively). Determination is made by Division 974 of the Income Tax Assessment Act 1997 (Cth). Broadly speaking, it operates to treat all holders of: ordinary shares; preference shares; convertible securities; and securities, the returns of which are a function of target performance, as holders of equity interests provided that they do not also satisfy the requirements of a debt interest. Usually, an arrangement will satisfy the requirements of a debt interest if the entity subject to it has an effectively non-contingent obligation under the arrangement to provide a benefit in the future (e.g. the repayment of a loan) and it is substantially more likely than not that the value provided will at least be equal to the value received.

Off-shore tax structures are common in the Australian private equity landscape. Traditionally, the legal vehicle most commonly used has been the limited partnership domiciled in a jurisdiction offering tax neutrality, such as Delaware, the Cayman Islands or the British Virgin Islands. Australia has been proposing a new corporate collective investment vehicle (CCIV) regime since 2017, without implementation to date. In the 2021–22 Federal Budget, the Australian Government announced that it will progress the tax and regulatory framework for the CCIV with a new commencement date of 1 July 2022. The proposed CCIV regime will provide investors with the ability to obtain deemed capital gains tax (CGT) treatment and a reduced rate of withholding tax when investing from a country that has entered into an exchange of information agreement with Australia.

It is also worth noting that the Australian Taxation Office (ATO), in its efforts to combat multinational tax avoidance, continues to review the structures created and held off-shore by multinational corporate groups to which Australia's cross-border and general anti-avoidance rules may apply.

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)?

Shares and options granted for less than market value may be subject to employee share scheme (ESS) provisions resulting in gain being taxed as income rather than capital. The taxing point under those provisions is either upon grant or on a deferred basis (i.e. until vesting or exercise). Tax may generally be deferred for qualifying options until exercise, rather than vesting. To qualify for deferral, an employee can hold up to 10% of the ownership interests of the employer for up to 15 years from grant.

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?

Australia imposes a somewhat complicated CGT regime on many investments, which may apply to individuals within any local management team. The ability to access CGT concessions and be able to roll over any capital investment into a new investment without triggering an immediate CGT liability may be important to management teams when considering a new acquisition structure.

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 3 September 2020, the Treasury Laws Amendment (2020 Measures No. 2) Act 2020 received royal assent, resulting in a number of amendments to Australia's hybrid mismatch rules in order to clarify and improve the rules' operation. Notably, the amendments ensure that the integrity rule applies to financing arrangements seeking to prevent multinational groups from circumventing the hybrid mismatch rules by routing investment or financing into Australia using interposed entities.

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?

ARFP

The Asia Region Funds Passport (ARFP) is an initiative led by the Asia-Pacific Economic Cooperation (APEC) with the objective of attracting and keeping finance within the region to foster its economic growth and strengthen the investment management industry. Five countries (Australia, Japan, Korea, New Zealand, and Thailand) signed a Memorandum of Understanding to participate in the ARFP.

The ARFP has been live since 1 February 2019. Australia, Japan and Thailand are ready to receive registration applications from local prospective Passport funds and entry applications from foreign Passport funds. Korea and New Zealand continue to make progress with the legal and regulatory requirements for implementation required in their respective jurisdictions. The APEC is continuously promoting the ARFP scheme to other member countries for consideration. Potential new joiners could include India, Indonesia, the Philippines, Singapore and Vietnam (currently observers in the ARFP working group). The ARFP allows units of funds authorised in a participating country (home jurisdiction) to be offered in other participating countries (host jurisdictions) upon approval as an ARFP fund and host jurisdiction authorisation. The ARFP emphasises investor protection by ensuring that participating countries meet the standards of the International Organization of Securities Commissions (IOSCO).

Key requirements of an ARFP fund are that it must:

- Be constituted or established as a regulated Collective Investment Scheme (CIS) or a sub-fund of a regulated CIS in one of the participating ARFP jurisdictions.
- Be distributed in its home jurisdiction.
- Have a net asset value of at least US$500 million.
- Only invest in specific asset classes: transferable securities; money market instruments; deposits; depositary receipts over gold; derivatives; and units of other funds. Further details can be found in the ARFP rules document.

The fund's operator must have a minimum capital of US$1 million, plus 0.1% of AUM above US$500 million of AUM, up to US$20 million.

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

It would be unfair to suggest that the regulatory scrutiny of investors or transactions in Australia at present, by bodies such as the FIRB or the ACCC (as to which, see the answer to question 4.1), is necessarily any more intensive in respect of private equity investors or the transactions that they normally contemplate, than for other investors.

It should, however, be noted that, as of 1 January 2021, the pre-COVID monetary thresholds for "notifiable actions" and "significant actions" are reinstated and indexed for 2021. In particular, "notifiable national security actions" will need to notify the FIRB regardless of value. Generally speaking, a notifiable security action is an action to:

- start a "national security business" (a business, carried on wholly or partly in Australia, for profit or not, and which is publicly known or could be known upon the making of reasonable inquiries that the business is involved in or connected with a critical infrastructure asset, telecommunications, defence or a national intelligence community or their supply chains);
- acquire a "direct interest" (usually 10% or more) in a "national security business" or an entity that carries on a "national security business"; or
- acquire an interest in "national security land" (generally land that is a defence premises or where a national intelligence agency is known to have an interest).

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.)?

Investees should expect a level of detailed due diligence from private equity investors in Australia that is comparable to that undertaken in similar jurisdictions, e.g. the UK and US, customarily principally driven by financial due diligence on revenues and assets, but also extending to regulatory compliance depending on the industry (especially in financial services). Financiers and warranty and indemnity insurers can demand their own detailed diligence processes with their own external counsel and should not necessarily be expected to merely be content to "piggy-back" investor due 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.)?

Private equity investors will clearly seek protection in the context of avoiding acquisitions of Australian businesses that conduct business in sanctioned jurisdictions or have relationships with sanctioned or politically exposed persons. Applicable risks are typically excluded from warranty and indemnity insurance coverage, such that an investor would commonly seek contractual protections by way of specific indemnity.

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 corporate veil can be pierced such that a private equity investor may suffer liabilities as a result of the actions of an investee portfolio company 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 order that an accessory (which can include shareholders) be liable to back-pay employee entitlements.

It should be very rare that a portfolio company be held liable for the liabilities of another portfolio company outside of contractual cross-guarantees, but it could conceivably occur if group arrangements are deemed to be a fraud/sham and the corporate veil pierced.

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?

Australia is a relatively open economy with a freely floating currency and no foreign exchange controls. It has well-developed financial markets and a sophisticated professional services sector, with a strong and impartial legal and judicial system that remains very similar to that of the UK. It is thus a jurisdiction posing relatively few concerns to private equity investors.

These responses describe the law and policies in force as at 16 July 2021. The above is intended for general information purposes only and is not intended to constitute the giving of any legal advice (which should always be specific to individual circumstances) and, therefore, the above should not be relied upon as advice by any person for any purpose.

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Clients for whom the firm has acted include: LSE premium-listed Asia Resource Minerals plc; Glencore plc (and Ivan Glasenberg); Glencore International; WIN Corporation and Bruce Gordon; Consolidated Press and Publishing and Broadcasting companies; Messrs James Packer and Peter Yates; and four former non-executive directors of James Hardie Industries.

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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?

Austria has seen the full spectrum of private equity transactions.

In the large-cap (buyout) segment (deals values of EUR 100 million and above) the main trend over the last 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 mid-cap (buyout) segment (comprising deals with values between EUR 10 million and EUR 100 million, which make up the vast majority of Austrian deals) and typically target family- or founder-owned businesses, tax-optimised roll-over structures were often used, which allow founders or other sellers to reinvest part of the sale 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 is increased activity in the growth capital segment and the venture capital segment where corporate accelerator and venture capital funds are becoming increasingly active and are causing significant competition for traditional venture capital funds. Investors from Asia (in particular, China and India) are also regularly playing significant roles.

On the debt side, specialist debt funds have become increasingly active over the last 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 loans and DIP loans.

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

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 investment mandate. With CEE developing, we have seen this becoming a lesser issue over the last couple of years.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

As anticipated, the COVID-19 pandemic resulted in new opportunities for special situations funds and generalist funds, with a broader investment mandate. Transactions could take various forms, including straight buyouts to hybrid equity. Dedicated distressed situations funds and debt funds active in stressed financing also had some deal opportunities. However, we have seen less distressed situations in which the seller had to divest non-core businesses, e.g. based on the pressure from the banks, or because the target company itself had been in a distressed situation, as most would have expected in the first place. Therefore, the majority of transactions are actually non-distressed and we have seen a very high level of deal activity. Government activity has probably had no effect when it comes to deal activity; however, the government plans to issue fund formation legislation to attract funds locally.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

We have seen a significant increase of investment holding activity over the last two to three years, which mainly comes from Germany. Investment holdings tend to have an entrepreneurial background and their capital is usually sourced from entrepreneur families only. The main difference to traditional private equity is their evergreen structure, which allows them to invest longer term and put less focus on exit provisions. Their entrepreneurial background often gives them a competitive advantage in auctions where family-owned businesses are up for sale.

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 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 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 multi-layer HoldCo and BidCo structures was the availability of goodwill amortisation on share deals and that capital tax on capital contributions could be avoided through indirect parent contributions; neither have any relevance anymore. 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 through (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 contractual bonus scheme arrangements, as gains realised upon an exit may be eligible for capital gains taxation.

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 shares upon an exit and will often insist on pooling of the management shares 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 resigns on his own initiative without cause (*ohne wichtigen Grund*). More sophisticated provisions specifically define good leaver and bad leaver cases (this includes dismissal for pre-defined "causes", which covers things like felonies against the company such as fraud or embezzlement and breaches of material obligations). Resignation without cause is typically seen as a bad leaver case unless the manager has "good reasons" for his resignation (e.g. health). Attaining retirement age, death or permanent incapacity or disability are typically seen as 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 (equity) incentive scheme (see question 2.3) and that all of the management team (and sometimes also certain other key personnel) enter 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 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 threshold. Where multiple private equity funds invest, they will generally insist that all investors agree and vote on a 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 where 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 the employee's 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?

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 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 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).

A private equity investor will generally not be held responsible for an act or a failure to act as 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 must 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, foreign direct investment 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 Investment Control Act (*Investitionskontrollgesetz* – "*InvKG*") (the direct or indirect acquisition of voting rights (thresholds vary depending on the sensitivity of the sector) or an (otherwise) controlling interest or of material assets of a business involved in certain protected industries by a non-EEA or non-Swiss national is subject to approval of the Federal Ministry for

Digitalization and Business Location. Micro-enterprises with fewer than 10 employees and an annual turnover or balance sheet total of less than 2 million are in any case exempt).

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 increasingly 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 used, in particular where private equity investors are sellers.

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

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.

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 as 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 (i) a private equity seller, and (ii) the 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 must 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 themselves 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 it is 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 that 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.

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 that 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 an 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 buyer (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 and 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) that limit the private equity seller's ability to 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 usually 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 and not for the financing of the transaction. Generally, recent deals show a noticeable increase in financing provided by debt 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?

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.

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.

In addition, please note that, as a general rule, tax authorities may request the disclosure of the eventual recipient (whether related or non-related) of any expenses deducted and that such rule also applies to interest expenses. In particular, in relation to funds acting as lender, such disclosure rule may be burdensome to comply with.

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. In such structures, we also see an increased level of substance (in terms of own premises and personnel) in the foreign entities, which then usually provide internal services to related entities.

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. In a typical case, where the 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. Recently, the rules for individuals applicable to such transactions in a cross-border context have been adopted to expand the options for managers to avoid taxation upon the roll-over.

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

Since 1 January 2019, CFC rules for "controlled foreign companies" and permanent establishments have been implemented that 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 couple of years ago. Binding tax rulings are meanwhile also available in the areas of international taxation and for questions in connection with abuse (since 1 January 2019) and value-added tax (since 1 January 2020). In practice, we increasingly see ruling requests in relation to pre-exit reorganisations, but also in relation to transfer pricing issues.

Anti-hybrid rules

The Tax Reform Act 2020 foresees anti-avoidance rules targeting hybrid cross-border structures. Specific structures leading to a tax deduction in one state without any corresponding taxable income in the other state (deduction/no inclusion) as well as structures enabling a double tax deduction in two different states (double deduction) shall be prevented. The new provisions shall apply to specific structures defined by law (e.g. hybrid financial instrument, hybrid transfer, hybrid entities, hybrid private equity and unconsidered private equity) and shall lead to tax deduction of expenses failed and/or taxable income in Austria as well as to tax deduction of expenses failed in Austria. The new rules for hybrid cross-border structures apply as of 1 January 2020.

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) that should be considered where real estate is involved.

Reporting regime

On 1 July 2020, the EU Reporting Obligation Act came into effect, which requires the reporting of certain cross-border tax arrangements. This act implements an EU directive (DAC 6) that must also be applied in the other 26 EU Member States.

A cross-border arrangement is subject to reporting if it involves a potential risk of tax avoidance or of circumvention of the reporting obligation under the Common Reporting Standard or of preventing the identification of the beneficial owner and (i) its first step was implemented between 25 June 2018 and 30 June 2020 (so-called "old cases"), or (ii) its first step is implemented from 1 July 2020 or it is designed, marketed, organised, made available for implementation, or managed from 1 July 2020. A distinction is made between arrangements that are subject to mandatory reporting and those that are subject to conditional reporting. In any case, arrangements that are subject to a mandatory reporting obligation must be reported, regardless of whether a potential tax advantage has been obtained. The obligation to report a cross-border tax arrangement is generally imposed on the so-called intermediary. An intermediary is any person who designs, markets, organises, makes available for implementation, or manages the implementation of an arrangement subject to reporting requirements. Accordingly, in each transaction, it has to be analysed whether such new reporting regime applies or 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?

As one of 18 EU Member States so far, Austria established a new investment control regime in July 2020; its importance for private equity investors ultimately controlled by persons hailing from outside of the European Economic Area or Switzerland can hardly be overstated. Direct and indirect acquisitions of: (i) voting rights of 25% or 50% (in critical sectors 10%); (ii) a decisive influence in an Austrian company; or (iii) significant assets in sectors such as defence, energy, digital infrastructure, R&D, but also IT, public transport, health, telecommunications, chemicals, robotics, semiconductors, nuclear and biotechnology, food supply, supply of pharmaceuticals, vaccines, medicinal products and media, which are considered to be of critical importance for security and public order in Austria, will require approval by the Austrian Ministry of Digital and Economic Affairs. Approval may be granted subject to certain conditions. An investor failing to obtain approval before closing may face administrative and even criminal sanctions. In addition, an investment is deemed void until approval has been obtained. Since the investment control proceeding will take between two-and-a-half months in simple cases and five to six months in more complex cases, the transaction documents should provide for sufficient time between signing and closing.

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 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 contact through trusted advisors. Post-COVID-19, however, an increased level of appetite to sell is expected.

In relation to listed target companies, investors should be aware that there is often limited free float and one or two major block shareholders, which, even though they might not own a majority, control the company.

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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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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?

The most common types of private equity ("PE") transactions in Brazil are acquisitions of controlling or minority stakes in: (i) middle-market private companies with growth potential; or (ii) smaller private companies in niche markets that are in the process of consolidation. These transactions are followed by an exit through an IPO or M&A with a strategic player.

PE transactions are having their best year in 2021. Low interest rates have made it easier for PE funds to raise capital from Brazilian investors, the abundance of liquidity abroad and a depreciated real exchange rate have made Brazil a more interesting destination for international capital, and the resurgence of the Brazilian IPO market has allowed PE funds to find quicker exits with improved returns. On the flipside, there has been more competition for investment opportunities, which brings about richer valuations and more seller-friendly agreements.

While many industries have been substantially impaired by the COVID-19 crisis, many Brazilian industries are thriving during the pandemic, such as e-commerce, healthtech, fintech and information technology in general.

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

There are several factors encouraging PE transactions in Brazil, such as a depreciated exchange rate, a large internal market, solid institutions and a stable legal framework. Diminishing returns to investors in traditional investments have created the perfect scenario for PE funds to raise capital and for portfolio companies to perform IPOs (which resulted excellent exit opportunity for PE investors).

Factors that generally inhibit PE investments in Brazil are constant political crisis, complex bureaucracy, inflation, high national debt and a lack of legal certainty. The Government's promise to implement much-needed structural reforms created some expectation that economic conditions would improve with free-market-oriented policies. However, progress has been slow and Brazil once again finds itself in the middle of a political crisis, now resulting from the government's response to the COVID-19 pandemic. In addition, the Brazilian Government has recently revealed a tax-reform plan that has not been well received by the business community and there is a risk that Brazil may be on the verge of an energy crisis.

None of these recent negative events have diminished the appetite for PE transactions, which continue to soar.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

While PE activity is surging amid the COVID-19 pandemic, the full extent of its economic impact is not yet known. An increase in the U.S. interest rate and a reduction of liquidity worldwide could make it more difficult for PE funds to raise capital and divest assets. The Brazilian Government's response to COVID-19 has had mixed effects on the economy as a whole (and the PE industry in particular). On one hand, the Government offered aid to a significant portion of the population and released several lines of credit to small- and medium-sized companies, which may have prevented a deeper economic crisis. On the other hand, the Government's intervention in certain industries (such as oil and gas) and the increase of an already high national debt have created concerns for the Brazilian economy moving forward.

In any case, strongly capitalised PE funds are always well placed to take advantage of investment opportunities that may arise from the uncertainty.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

Low returns of fixed-income assets have pushed many investors to the PE industry. While smaller investors have started to invest in traditional PE funds, some family offices and high-net-worth individuals took the next big step and are making PE-style transactions directly. The main point of difference in transactions made by family offices and high-net-worth individuals is that these investors are generally less concerned with governance rights – they tend to invest in companies already backed by a PE fund or that have a very strong leadership team.

2 Structuring Matters

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

Onshore and offshore PE funds will usually structure an investment fund called an FIP (*Fundo de Investimento em Participações*) to either fundraise (in onshore funds) or to serve as vehicles for acquisitions. FIPs are a "condominium of assets" regulated by the Securities and Exchange Commission (*Comissão de Valores Mobiliários* or "CVM"). Onshore PE sponsors (or offshore sponsors with a dedicated onshore presence) will usually act as the manager of the FIP, with powers to decide on investments and divestments.

The acquisition structures in PE transaction are not particularly different from general transactions in Brazil. The FIP may directly acquire a stake in a portfolio company or incorporate an intermediary holding to perform the transaction. The holding structure is more common as it affords financing with debt and the use of goodwill amortisation tax benefit.

2.2 What are the main drivers for these acquisition structures?

FIPs have long been the vehicle of choice for PE transactions due to a more tax-friendly regime (especially for foreign investors).

As for the acquisition structures for PE transactions, the main driver for creating an intermediary holding is to be able to finance all or part of transactions with debt and to be able to benefit from goodwill amortisation for tax purposes.

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

PE sponsors create an investment fund and obtain funding. PE sponsors often act as the manager of the fund, receiving management fees as compensation. After funding, the fund seeks opportunities to invest in portfolio companies, generally in the form of equity. If debt financing is used, a Brazilian business entity is created to issue debt and is then placed between the investment fund and the portfolio company. On minority acquisitions, founders of the portfolio company generally continue to hold key positions and equity.

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

There are no different structuring considerations for transactions where a PE investor is taking a minority position. However, a PE investor with no control generally seeks additional contractual protections against abuse by controlling shareholders, governance rights to secure an active role in the company, and exit strategies to allow for divestment alternatives.

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 varies across industries and depends on the stage of the company and the investment amount. Management equity is generally issued in the form of stock options. Vesting is typically time-based, with manager's equity increasing in increments over a specified period of time, and can take the form of straight-line or cliff. While there is no consolidated practice, option pools generally range from 5–15% and vesting periods from three to five years. It is common to see clauses in stock option plans imposing a compulsory sale of shares back to the company (or cancellation of vested options) if the professional resigns or is terminated for cause.

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

Death and permanent incapacity are invariably good leaver events, and voluntary resignation and dismissal for cause are typically bad leaver events. The definition of "dismissal for cause" and all other circumstances are a matter of negotiation.

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 requires FIP portfolio companies to have minimum governance requirements such as: (i) a unified two-year term of office for all directors; (ii) a disclosure obligation for related party transactions; (iii) arbitration to settle disputes; (iv) annual auditing of financial statements; and (v) prohibition of issuance of any beneficiary bonds (*partes beneficiárias*). FIPs are also generally required to have an active role in the company's management.

Governance arrangements for PE portfolio companies are typically documented in a Shareholders' Agreement, which are private contracts not required to be made publicly available unless the portfolio company is public.

Governance matters are also included in the company's bylaws, which are public in Brazil. The bylaws generally contain less granularity on particular rights of the FIP.

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?

FIPs normally enjoy extensive veto rights over major corporate actions (including mergers, increase, reduction of capital stock and SOP programmes) and strategic decisions (including relevant acquisitions and disposals, major litigation, incurring indebtedness over a certain threshold, and relevant changes to business plans and budgets) through shareholder veto rights and/or director veto rights exercisable by their nominee directors. These vetoes are usually structured in such a way that management's ability to make ordinary decisions is not hindered.

The number and relevance of veto rights depends directly on the equity stake acquired by the FIP and is subject to intense negotiation. In a minority investment, the list of veto rights afforded to the FIP will be reduced and vetoes will be more important to protect the FIP against abuse by the controlling shareholder (e.g., vetoes in 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?

Shareholders' Agreements are binding and subject to specific performance. The chairperson of shareholders' meetings and of board meetings is required to refuse and ignore any vote that is cast against the terms of the Shareholders' Agreement. There is some discussion as to whether a Shareholders' Agreement can limit the independence and direct the voting of a board member, particularly in listed 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?

There are no duties and/or obligations applicable specifically to PE investors, but PE investors are generally required to vote in the best interest of the portfolio company (just like any other shareholder). When taking a controlling stake in a company, PE investors should consider that Brazilian law has regulations protecting other shareholders from abuse of controlling power and exercise of voting rights against minority interest. Board members appointed by the PE investors owe fiduciary duties to 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)?

There are no general limitations on enforceability or content of Shareholders' Agreements, provided that their provisions are not in breach of Brazilian law. Non-solicitation is fully enforceable and non-compete covenants are also enforceable as long as their restrictions are limited to the business being acquired and that they meet the following requirements: payment of compensation; limitation of the applicable territory; and time limitation (generally of up to five years). Shareholders' Agreements may be governed by foreign law and be subject to foreign jurisdiction, but this is uncommon – a Shareholders' Agreement subject to foreign law and jurisdiction would be harder to enforce in Brazil.

Shareholders' Agreements are subject to specific performance when registered at the portfolio company's headquarters.

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 have an unblemished reputation, and not have been sentenced for certain crimes such as misappropriation of funds, bankruptcy fraud, bribery or any crimes that would bar them from taking public office. Management may be held jointly liable for the portfolio company's obligation in limited instances involving fraud or acts that violate the law or the portfolio company's bylaws. Brazilian judges tend to have aggressive approaches against officers and directors in cases of environmental disasters and labour disputes, particularly if the company is unable to pay. Tax authorities sometimes also try to pin responsibility on managers for illegal tax planning. The most common liability protection for officers and directors is D&O insurance and hold harmless letters.

There is no particular increase in responsibility for PE investors that nominate directors to boards of portfolio companies (although they may be subject to stricter insider-trading restrictions if the portfolio company is public).

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 owe fiduciary duties to the company. Such duties include duty of care, loyalty, and the obligation to act in the best interest of the company. Board members cannot, as a matter law, act against the best interest of the company to protect an interest of the shareholder that has nominated them. Board members also cannot vote in matters where they have a "personal" conflict of interest.

Taking management positions in other portfolio companies does not automatically create a conflict of interest or any other restriction to the board member, to the extent that the board member continues to act in the portfolio companies' best interest.

4 Transaction Terms: General

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

Under the Antitrust Law, prior approval from the Brazilian Antitrust Authority ("CADE") is required whenever a transaction constitutes a "concentration act", the definition of which includes M&As where one of the parties registered annual gross sales or a total turnover in Brazil greater than R$ 750 million and another party registered annual gross sales or a total turnover in Brazil greater than R$ 75 million, both in the year preceding the transaction. Review of the transaction by CADE generally takes around 30 days for simple transactions but may take up to 240 days (extendable for another 90 days) for complex transactions. CADE has the ability to impose restrictions on a transaction or prohibit its consummation.

PE transactions within regulated sectors (banking, insurance, mining, etc.) may also require prior authorisation from the relevant authority.

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

Traditionally, sellers in most Brazilian transactions assume full liability for the target's pre-closing liabilities. More recently, as the market has shifted towards a seller's market, there has been a trend towards increasingly seller-friendly agreements, with more restrictions to liability (including smaller caps) and less conditionality.

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 generally made in the same fashion as private transactions when target has a controlling shareholder. The main difference is that a buyer that acquired a controlling interest in a public company is required to launch a mandatory tender offer to acquire all common shares held by minority shareholders of the target (and, in some instances, also preferred shares). Acquisitions of a controlling interest in public companies that do not have a controlling shareholder are generally made in the form of tender offers (takeover bids).

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

PE investors making a private deal with the controlling shareholder of a public company tend to seek the same level of protection as they would have in a private acquisition (including, when applicable, break-up fees). When making a Takeover Bid, PE investors generally do not have any legal protection. Takeover Bids are subject to buyer interference.

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 funds generally negotiate often exhaustive representations and warranties, seek indemnification for all pre-closing liabilities of target, implement more complex payment structures (tranches, earn-out) and request a number of different guarantees (holdback, escrow, collateral, etc.).

On the sell-side, PE investors sometimes agree to provide representations and warranties and indemnify for all pre-closing liabilities, though this is a highly contentious and negotiated matter. When PE investors agree to indemnify the buyer, they look for more limitation to indemnities, reduction of guarantees (e.g., lower or no escrow) and more ordinary payment structures (single tranche, no earn-out).

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

In Brazilian transactions, it is common for a seller to provide a full package of representations and warranties (including business and operational warranties) and to indemnify the buyer for all pre-closing liabilities. When the PE investor has taken a more passive role in the portfolio company, it generally tries to limit representations and warranties to fundamental only (authorisation, title to shares, etc.) and to avoid indemnity for pre-closing liabilities, but these are generally highly contentious and negotiated aspects of any sell-side PE transaction.

Founders that continue to be principal shareholders generally provide a full package of representations and warranties and undertake to indemnify the buyer for pre-closing liabilities *pro rata* their stake in the company.

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?

It is standard in Brazil for sellers to undertake to keep targets operating in the ordinary course of business until closing. Brazilian agreements generally contain a list of pre-closing actions that sellers and the company cannot take without the buyer's consent. Confidentiality is standard in Brazilian transactions, as are general covenants to act diligently to satisfy conditions precedent and to assist the other party in regulatory filings. Founders (and less often, PE investors) sometimes agree to non-solicitation and non-compete 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?

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, basket and cap. Such limitations are generally subject to complex negotiations.

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)?

On the buy-side, PE investors generally ask for a number of different types of guarantees (holdback, escrow, collateral, etc.). Security is usually tied to diligence findings and release is made at a pre-determined drop-dead date. On the sell-side, PE investors generally try to limit the securities offered, but buyers often argue that normal indemnification against PE investors may be unenforceable (for all practical purposes) after proceeds are distributed to the FIP's investors. Hence, escrow accounts are not uncommon in sell-side 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 buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Generally, PE deals are not subject to financing conditions and sellers do not require debt or equity finance commitments. Comfort is generally derived from the transaction documentation and the PE fund's existing cash or existing commitments from investors. When present, equity finance commitments are more common than debt finance (the latter still being rare in Brazil). If the PE investor fails to close the transaction for any reason (including lack of funds), sellers may seek court relief to enforce their rights under the transaction agreement or any equity finance or debt commitment that has been delivered. Specific performance and damages are available for these types of defaults.

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 PE transactions involving private companies.

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?

In the last few years, with the resurgence of the Brazilian capital market, IPOs have become the most lucrative form of exit for PE investors. Between 2020 and 2021, there were more than 50 offerings in Brazil, surpassing the figures for 2007. Improvement of economic and political conditions, free-market-oriented policies and the constant development of the capital market's regulations by the CVM and the B3 stock exchange have enhanced confidence in the Brazilian capital market, making it a better and safer destination for the flow of Brazilian and international capital.

Of course, IPO exits present some complexities, which are not particular to Brazil: (i) market conditions may not allow a PE fund to have a full exit, and remaining shares may be subject to lock-up; (ii) an IPO involves substantial costs and a somewhat long registration process; and (iii) an IPO exposes PE sellers to significant markets risk compared to more certainty of private deals. This last feature is particularly relevant in Brazil, which has had its share of political instability over the last few years.

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

A PE investor holding a controlling or a relevant stake in a portfolio company is generally required to accept a lock-up of around six months. PE investors holding a minority stake tend to refuse being bound to lock-ups, which may be a cause for complex negotiations within the IPO process.

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 were rare in Brazil, as economic conditions made IPO exits difficult. Before 2019, most PE exits were made through M&As with strategic players, so carrying out a real dual-track process served no real purpose. However, as IPO exits have now become an interesting alternative to PE investors, we have been seeing an increasing number of dual-track processes in the Brazilian market. In general, when pursuing a dual-track exit strategy, investors wait until the deal becomes public to decide which route to take. We have seen deals where the PE investors decided to continue to run the dual track throughout the whole IPO process, but it is rare for a sale process to continue after the portfolio company begins the "road show" in relation to the IPO. While there is no particular standard, we have recently been seeing more dual-track transactions 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 finance in PE deals continue to be bank-led loans and bonds. The market for high-yield bonds has not been historically great in Brazil, but this trend may be shifting as a result of record-low interest rates in traditional bonds.

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 leveraged transactions, typically the debt will be incurred by the acquisition company sitting immediately below the FIP. This intermediary holding company is financed with equity from the FIP and debt from creditors.

Other than that, there are no Brazilian law requirements or restrictions that would impact the nature or structuring of the debt financing in PE transactions, and such considerations will largely depend on the particular circumstances of the transaction in question.

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

As mentioned above, record-low interest rates have forced investors to turn to more aggressive types of investment. This shift has the potential of benefitting the market for debt financing in PE transactions and high-yield bonds. Regulation has also been moving in that same direction, with the CVM now allowing at least a portion of FIPs (those that receive financial support from development agencies and institutions) to take on debt directly, without more complex structures involving intermediary holding companies. More sophisticated debt financing structures are bound to become a feature of the Brazilian PE market as a result of the increased presence of alternative lenders, foreign PE investors and international sources of 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?

As mentioned above, the choice for the FIP structure is mostly based on a more tax-friendly tax regime (especially to foreign investors) and the protection afforded to investors against liabilities of the portfolio companies.

As a general rule, FIPs are exempt from taxation on capital gains and income from portfolio companies. Such taxation is deferred to the moment when the proceeds are distributed to the FIP quotaholders. Moreover, non-resident investors: (i) whose investments are registered under the tax regime applicable to investments in the capital markets (CMN Resolution no. 4,373/2014); and (ii) that are not headquartered in tax havens (mainly regions that tax capital gains a rate lower than 20%) may benefit from a special exemption from taxes on capital gains.

The downside of the FIP structure, particularly for Brazilian investors, is that while dividends are tax-free in Brazil, the remuneration paid by the FIP to its investors is taxable by normal capital gains rules.

Recently, the Brazilian Government has sent to Congress a tax reform proposal that, among others, may impact the FIP structure. Under the proposed terms of the tax reform (which is expected to be thoroughly reviewed by Congress), FIPs that are not classified as "investment entities" will:

(i) become subject to the same type of taxation as legal entities in general; and
(ii) be required to pay taxes on undistributed gains existing on January 1, 2022.

Under existing regulations, the following are characteristics of FIPs that can be classified as "investment entities": (i) having more than one investment; (ii) having more than one investor; (iii) having investors that do not influence the manager or that are not related parties to it; and (iv) investing in entities that are not related parties to the investors. In practice, the definition of what constitutes an "investment" FIP is expected to become subject to intense debate.

Finally, offshore structures are common for portfolio companies that are intending to raise funds abroad.

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)?

See question 9.1 above for the rationale of incorporating an FIP. An analysis of tax-efficiency in the investments on portfolio companies should be made on a case-by-case basis, as it depends on several aspects of the transaction. There is no general formula applied to PE investments as a whole.

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?

In selling and/or rolling over their investments into new acquisition structures, management teams are generally concerned with capital gains taxation. Generally, rollovers are made via asset contribution into a new vehicle. Provided that the rollover is made "at cost", capital gains taxation can be deferred to the moment when the shares are ultimately sold. When the new structure is an FIP, there are instances where legislation requires the rollover to be made at the fair market value of the assets. In these cases, capital gains taxation is immediately levied.

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?

See our response to question 9.1 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 mentioned above, the current Brazilian Government was elected on the promise of making a series of much-needed structural reforms. In the last few years, Brazil passed a Social Security Reform and the Economic Freedom Act, a legislation aiming to improve the business environment in Brazil. As part of the Economic Freedom Act, limited liability in investment funds was consolidated in the Brazilian Civil Code.

Moreover, the government and/or regulatory agencies (such as the CVM and Central Bank) were able to approve recently: (i) a bankruptcy law reform; (ii) a legal framework for start-ups; (iii) a legal framework for open banking; (iv) regulatory sandbox and crowdfunding act reform; and (v) the Brazilian Data Protection Law.

Currently, the Government is trying to pass a tax reform (as discussed in answer to question 9.1 above) and an administrative reform.

Specifically in respect of FIPs, the CVM has amended its existing regulation to segregate FIPs into different categories depending on the composition of their portfolio and, by doing so, was able to authorise certain types of FIPs to carry out transactions that were previously restricted. Currently, certain types of FIPs are allowed to have "qualified investors" (instead of "professional investors", which is a more restricted definition) and are authorised to invest in limited liability companies (*sociedades limitadas*) and in companies located abroad. The requirement that FIPs have influence over the target company's management was also made more flexible in some instances.

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

Investments in regulated sectors (banking, telecoms, insurance, healthcare, energy, mining, etc.) require prior approval by the competent authority and tend to be subject to a high level of scrutiny by the competent regulatory agencies, sometimes on the 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.)?

PE investors generally carry out a thorough due diligence process, though the exact level of the diligence varies from transaction to transaction and is dependent on several factors, including the size of the target. The level of diligence also depends on whether the sale is bilateral or by way of auction, which may limit the scope and timeframe. During the due diligence process, external legal counsel and auditors are almost always engaged to review the documentation and information made available directly by the target or by its financial advisors. The due diligence report is generally prepared on a "red flag issues" basis, with materiality thresholds reflecting the size of the deal.

Tax, environmental and anti-bribery have always been areas of particular interest for PE investors (and buyers in general) due to the size of potential liabilities. More recently – and following the enactment of the Brazilian General Data Protection Law – compliance with data protection rules has also become an important part of the due diligence process, particularly in the case of companies that have access to sensitive data from consumers, employees or other individuals.

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, as a result of "Operation Car Wash", compliance and anti-corruption are a general cause for concern for buyers of Brazilian businesses, with such matters being subject to extensive diligence and contractual negotiation (e.g., exclusion from cap and time limitation).

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 Economic Freedom Act provides that investors should not be liable for the debts and liabilities of the PE fund (i.e., investor's liability is limited to the amount of its investment). This is still subject to regulation by the CVM, although some funds are already including this in their bylaws. Since portfolio companies are always incorporated either as corporations or limited liability companies, their shareholders or other portfolio companies held by the PE fund should also not be held liable for their debts and liabilities.

Under the Brazilian Civil Code, there are very limited instances where a shareholder may be held liable for the invested company's liabilities, and one of the purposes of the Economic Freedom Act was to make these instances even more narrow. Under Brazilian law, piercing the corporate veil should generally be limited to cases where there is evidence of fraud or where the assets of the parties are unduly commingled.

Regardless of the above, in specific areas of the law, the separate legal personality of each entity is sometimes not respected. Labour courts are famously aggressive in applying the disregard doctrine and even implicating officers and directors whenever wages or other labour rights have not been paid. The same is sometimes true in respect of consumer relations, tax and environmental matters (particularly when there are environmental disasters).

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 issues to be considered when planning a PE investment in Brazil that are not already addressed above. As discussed throughout this article, Brazil represents a very appealing location for PE investments, with a large internal market, solid institutions and a stable legal framework.

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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?

Notwithstanding a "pause" in deal activity between March–May 2020 at the onset of the COVID-19 pandemic in North America, the private equity industry proved resilient and quickly adapted to the new order, resulting in Canadian private equity deal activity remaining strong through the end of 2020. This level of activity has continued into the first quarter of 2021. Larger deals (over $1B) decreased in total deal value from $11.6B in 2019 to only $3.7B in 2020. However, middle-market deals continued to be a significant driver in terms of total value invested. The industrial and manufacturing sector and the information communications technology sector continue to capture the largest share of activity measured by both the number of deals and total value.

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

At the onset of the COVID-19 pandemic, restrictions on cross-border and inter-provincial travel, in-person meetings, site visits and other activities made it more difficult to perform the investigations necessary to complete appropriate diligence in a timely manner. Implications on representation and warranty insurance underwriting was uncertain. These constraints also caused private equity investors to be concerned about effective post-acquisition integration of acquired businesses. However, the industry quickly adapted and new diligence processes, underwriting protocols and integration procedures were developed.

Private equity firms continue to have high levels of dry powder on hand and acquisition financing is again readily available from third-party lenders.

Continuing economic uncertainty from the COVID-19 pandemic is the greatest single factor currently inhibiting deals, especially traditional buyout activity, as many sectors have taken huge revenue hits. In addition, unprecedented governmental support at both the provincial and federal level and related economic stimulus packages have helped to prop up many Canadian companies, allowing them to survive in the immediate short-term and avoid a distressed sale process. What happens to these companies when these stimulus packages end is, to a great extent, unknown.

From the private equity buyer's perspective, seller's valuation expectations remain high. Valuation multiples in Canada have remained high compared to long-term averages. According to Crosbie & Co., companies with an enterprise value of $100–$250M traded at an average of 8.6X, a premium of 43% to small companies with an enterprise value of $10M–$25M, which traded at an average of 6X. However, valuations remain increasingly difficult to conduct as operations and supply chain disruption are a key focus of risk assessment and investors have to understand the financial risks associated with a target's trading partners, suppliers and customers caused by the pandemic.

The Canadian Government announced a policy that it would increase its scrutiny of transactions subject to review under the Investment Canada Act with respect to investments in health-related sectors as well as sectors involved in the supply of critical goods and services. The lower Canadian dollar continues to make Canadian targets attractive to foreign private equity buyers.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

There has been significant government support of the Canadian economy during the COVID-19 pandemic, including wage subsidies, rent subsidies, loans (a portion of which may be forgiveable) and moratoriums on evicting defaulting tenants. These measures have influenced private equity activity by allowing certain companies to remain operating when they would have otherwise needed to shut down, allowing them to be acquired as a going concern by private equity interests.

The short-term impact of these government initiatives on private equity investment has to be factored into the impact on EBIDTA calculations for valuation purposes. EBIDTA will, in many cases, be artificially inflated due to significant costs having been subsidised by the government stimulus programmes. Buyers need to be aware and adjust where appropriate. Sellers are not always willing to accept such adjustments, particularly in a competitive sale process.

In the mid- to longer term, Canada was viewed as a relatively high tax jurisdiction pre-COVID-19 pandemic. Eventually, the cost of the many billions of dollars of government support provided will need to be repaid, with the expectation being that, over time, taxes will need to rise, resulting in Canadian businesses being less attractive as candidates for private equity investment.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

Family offices and institutional investors, such as pension funds, are becoming more active and independent participants in the private M&A space. If these investors are competing against private equity firms in an auction setting, then they tend to offer private-equity-like transaction terms, including the use of representation and warranty insurance. If it is not a competitive process, then their approach and timelines are often more closely aligned to that of a strategic purchaser. Since these investors generally have the ability to hold an investment indefinitely, they will be more willing to acquire businesses that include real estate assets and will be more willing to consider acquiring manufacturing operations that have "legacy issues".

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, 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. Buyouts remain the preferred form of investment, but minority investments, once only common in smaller growth equity deals, are a continuing and 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 $883,384 (as of 2020) 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 regard to their exit strategy. A minority interest is often taken by a private equity investor 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. The Canada Business Corporations Act now requires federally incorporated businesses to maintain a record of beneficial owners in their corporate records. Recent amendments to British Columbia's Business Corporations Act also require private companies to maintain a register of individuals with certain kinds of control over the company. Manitoba, Saskatchewan, Nova Scotia, and Prince Edward Island have also introduced similar amendments to their corporate legislation. While this information will not be public (under currently enacted legislation), it is indicative of a growing trend towards more transparency.

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 ("USAs") 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 to be automatically enforceable against a subsequent shareholder, which shareholder agreement sets forth veto arrangements, fetters the discretion of the directors or supplants the default provisions of corporate legislation where permitted, it must be unanimous in nature. At the director level, only certain powers of directors can be fettered by a unanimous shareholders' agreement and, most notably, the fiduciary duty owed by the director of a portfolio company to the company itself 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 and, as such, not automatically enforceable against a subsequent shareholder; it is subject to the articles and by-laws of the corporation and the provisions of the relevant corporate statute. In contrast, a USA is a creature of statute, provided that it is 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 a 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 the federal 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. Recent changes to the legislation in Ontario and Alberta have removed a similar requirement for resident Canadian directors, thus making those jurisdictions more attractive to foreign-owned private equity firms who want to have the boards of their Canadian portfolio investments aligned in terms of membership with those of their investments held outside of Canada.

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 liability on directors 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, foreign direct investment 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 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. In response to the COVID-19 pandemic, the Canadian federal government released a policy statement in April 2020 stating that, using existing powers, it will apply enhanced scrutiny under the Investment Canada Act to certain foreign investments, notably foreign direct investment relating to public health or critical goods or services.

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., continues to trend downwards. The Canadian market has also increasingly seen public-company style "no-indemnity" deals as in the U.S. market. Also, the use of representation and warranty insurance is increasingly being seen as standard 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 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. Earn-out provisions have become especially popular during the COVID-19 pandemic as a way for transaction parties to account for uncertain future performance without discounting a company's purchase price. The use of "locked box" structures is becoming more common 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 (i) a private equity seller, and (ii) the 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 representation by liberally using materiality qualifiers and by including an anti-sandbagging provision. Private sellers are also increasingly insisting on public-company style "no-indemnity" 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, in which a private seller's post-closing exposure is limited exclusively 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?

Representation and warranty insurance use is not universal, but, as noted above, has become commonplace and is increasingly popular in Canadian private equity transactions. Policy limits typically cap out at 10–20% of the purchase price of a transaction. Available coverage has become broader and, over recent years, the number of typical carve-outs and exclusions from such policies has decreased quite significantly. However, 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 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 buyer (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 contains a representation and warranty that the private equity investor has sufficient funds to provide the funding. A separate equity commitment letter is often provided by the private equity firm. Comfort letters from the third-party lender 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?

While traditionally seen as the gold-standard, ideal exit for a private equity seller, IPO exits are not that common in Canada. According to the Canadian Venture Capital and Private Equity Association, in 2020 the exit market saw the highest value of private equity-backed IPOs, being $14B across four IPOs, but the lowest number of IPO exits on record. 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?

Dual-track processes have not typically been popular in Canada. However, given the state of the market before the pandemic and the increased use of these processes in the United States, we expect to see them becoming more common in Canada as buyers continue to seek ways to hedge the risk of a failed attempt to go public while at the same time 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. 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. At times, senior secured debt is also 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 affect the choice of structure used for debt financing in Canadian private equity transactions. Canadian loans tend to be fully secured against all available collateral.

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

Most private equity firms typically use private lending as part of the financing for their Canadian transactions. According to Crosbie & Co., the average equity portion of the capital structure increased to 49% of all transaction value in 2020, which was a modest increase from 46% in 2019, resulting in a corresponding reduction in leverage employed.

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 affected 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 in 2018, impose goods and services tax obligations on investment limited partnerships. These changes imposed 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. The federal government recently implemented, effective July 1, 2021, a $200,000 annual limit on the eligibility of employees of certain businesses to claim a 50% tax deduction for stock option grants. This could affect the compensation packages required to retain and incentivise management.

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?

Amendments to the Competition Act (Canada) 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, the amendments to the Competition Act noted above are likely to increase the number of private equity transactions that trigger advance notice requirements under the Competition Act. 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 that 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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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?

The Cayman Islands is a key 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 routinely employed 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 financial markets spectrum makes it difficult to identify one specific change that has emerged. In 2021, the Cayman Islands has seen a dramatic increase in special purpose acquisition company ("**SPAC**") -related transactions. At a thematic level, offshore practice continues to evolve, being more multi-jurisdictional due to onshore and global developments, more complex as it addresses different, and at times conflicting, regulatory frameworks and more involved as investors seek tailored structures and products that respond to regional and global events.

1.2 What are the most significant factors currently 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 ("**LLC**"). The Cayman Islands has also recently enforced legislation providing for a limited liability partnership ("**LLP**") vehicle (see section 10).

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 that 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 are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

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. This is affirmed by continued robust transactional activity in 2021. The private equity industry continues to look to capitalise on current market opportunities, including those presented by the COVID-19 pandemic.

The Cayman Islands implemented a number of temporary measures (including the "virtual presence" of a witness to the execution of deeds) and relaxations (including those by the Cayman Islands Registrar with respect to the formation of Cayman Islands vehicles) to facilitate "business as usual" in the Cayman Islands during the height of the COVID-19 pandemic.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

There are a range of investors beyond traditional private equity firm, including family offices and trade buyers, seeking to acquire investments that are structured through Cayman Islands domiciled holding vehicles. Transaction terms, and approach adopted, are dictated by investor profile and other commercial considerations that are not affected by Cayman Islands legal considerations.

2 Structuring Matters

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

The majority of Cayman Islands private equity funds are established as limited partnerships, being the Cayman Islands-exempt limited partnership. It is also possible to structure a Cayman Islands private equity fund as a company, an LLC or a trust.

The Cayman Islands fund vehicle will generally invest via other Cayman Islands vehicles, including aggregator vehicles, or entities domiciled outside the Cayman Islands, such as in Delaware, 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.

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 considerations as opposed to 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, an LLC 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.

An LLC can be member-managed or can appoint a separate board of managers. There is significant flexibility as to governance arrangements with respect to an LLC, which can be agreed by the parties in the LLC 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 LLC 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.

Operator information, being director, manager or general partner details (as applicable), can be obtained from the Cayman Islands registry. Commercial arrangements are not publicly available and generally information will only need to be disclosed with consent or in limited, appropriate circumstances, such as 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.

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 typically 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 an LLC 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, the director risks incurring personal liability. As noted previously, there can be greater flexibility in this regard if a Cayman Islands LLC 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 Act (As Revised). 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 transactions involving conflicts.

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust, foreign direct investment 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.

Cayman Islands law, including entity enabling legislation, is sufficiently flexible to allow 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 (i) a private equity seller, and (ii) the 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 buyer (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.

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 CSX 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 an LLC cannot themselves be the subject of an IPO. Care also needs to be given as to how any proposed conversion is effected, and there should be 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 CSX 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 CSX 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-exempt companies, exempted trusts, LLCs 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, LLC 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 an LLC, an exempted trust or an exempted limited partnership) from the date of the undertaking, no law that is enacted in the Cayman Islands imposing any tax to be levied on 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 is 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 100 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 30 November 2020, the ability to register a Cayman Islands LLP under the Limited Liability Partnership Act (As Revised) was enforced. The registration process for an LLP is similar to that for other forms of Cayman Islands vehicles. An LLP combines the flexible features of a general partnership, but has the benefit of separate legal personality and affords limited liability status to all its partners. In the context of private equity, an LLP's features and flexibility provide additional structuring options for general partner or management vehicles or fund of funds or holding partnerships. The PF Act (as defined below) makes provision for registration of an LLP as a private fund. Given the relative infancy of the LLP, this chapter does not address the LLP in any material detail.
- On 7 February 2020, the Private Funds Act (As Revised) (the "**PF Act**") came into force pursuant to which certain closed-ended funds (termed "private funds") are required to register with the Cayman Islands Monetary Authority. The adoption and implementation of the PF Act reflects the Cayman Islands' commitment as a co-operative jurisdiction, is responsive to EU and other international recommendations and covers similar ground to existing or proposed legislation in a number of other jurisdictions.
- On 27 December 2018, the Cayman Islands published the International Tax Co-operation (Economic Substance) Act (As Revised) as a response to global OECD Base Erosion and Profit Shifting ("**BEPS**") standards regarding geographically mobile activities. The Cayman Islands Economic Substance regime robustly addresses the ethos of the legislation without materially impacting the private equity industry. 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 Cayman Islands Anti-money Laundering Regulations in October 2017 and further revisions continue to be made as international standards evolve, including by applying sanctions, including administrative penalties, that are intended to be effective, proportionate and dissuasive.
- The enactment of the Limited Liability Companies Act in 2016 provided for the formation of a new Cayman Islands vehicle: the LLC. 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 Act took place in recent years, and

additional enhancements are proposed. While neither the current law nor the proposed revisions make fundamental alterations to the nature, formation or operation of Exempted Limited Partnerships, the statute 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 Act even further in line with Delaware concepts and developing industry practices, including electronic closing platforms.

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

Certain private funds set up as Cayman Islands partnerships, companies, unit trusts and LLCs are required to register with the Cayman Islands Monetary Authority ("**CIMA**") pursuant to the PF Act unless out of scope on the basis set out in the PF Act. The PF Act also applies to non-Cayman Islands private funds that make an "invitation to the public in the Islands". Private funds registered with CIMA are required to have their accounts audited annually by an auditor approved by CIMA. A private fund is also required to submit its audited accounts, along with the Fund Annual Return to CIMA within six months of the end of each financial year. Registered private funds are also subject to certain operational requirements regarding valuation of assets, safekeeping of fund assets, cash monitoring and identification of securities.

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.)?

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 Act (As Revised) (the "**AC Act**") 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 Act replaced the provisions relating to anti-corruption and bribery that 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 Act 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 that 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 2020, the number of active exempted limited partnerships stood at 31,733, compared with 28,469 in 2019 and 26,011 in 2018. 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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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?

China's private equity ("PE") deal activity has seen a tremendous surge in 2020, in terms of both deal volume and value, despite the COVID-19 pandemic. At the onset of the COVID-19 outbreak in the first and second quarters of 2020, no country was spared, including China, and it had severely impacted the global economy as a whole. However, in the case of China, we witnessed the economy starting to regain its momentum post-Q2 of 2020, and PE deals have gradually recovered since then, against market predictions. PE transactions reached a record high in Q4 of 2020. Without the slightest doubt, a major contributing factor was a series of successful measures taken by the Chinese government to contain the COVID-19 pandemic. The rapid rebound of PE deals has been driven by strong demand and targeted investment in key sectors, in particular in the telecommunications, media and technology industries, backed by strong earnings.

In China, two broad PE transactional scenarios are usually considered: (i) PE transactions in a private or non-public listed company, which can either take the form of a limited liability company or a company limited by shares; and (ii) PE transactions involving a public or public-listed company as portfolio company, for instance, a private offering of shares by a public listed company.

According to the statistics reported by the Asset Management Association of China, PE investment funds have reached RMB10 trillion in assets as of the Q1 of 2021. With government reforms and issuance of favourable policies in healthcare especially, investment and financing in the biotechnology and healthcare sectors have seen a rapid increase. Overall, the PE investment industry in China is becoming more specialised, focused and targeted, giving rise to professional frontier areas and high-tech projects, such as unmanned aerial vehicles, artificial intelligence and mobile interactions.

With an ever-increasing number of PE investors shifting their focus on Environmental, Social and Governance ("ESG") investments over the last few years, ESG has become one of the significant criteria to guide investment in China, resulting in General Partners ("GP") gradually incorporating ESG principles into their investment strategies and consciously avoiding the risks associated with ESG.

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

In our view, three significant factors that we think that are driving and encouraging PE transactions in China in recent years are: firstly, supportive national economy policies backed by political administration stability; secondly, availability of world investment capital (be it from the government or from private sectors, domestic or international); and thirdly, less restrictive exit options for the players.

Since the launch of the Science and Technology Innovation Board ("STIB", also known as "SSE STAR MARKET" in China) at the Shanghai Stock Exchange in 2019, serving as Asia's Nasdaq-style tech board, the newly adopted registration-based listing system had replaced the filing and registration regime, which significantly sped up the approval and review process to take a company public.

Traditionally, IPOs in China are subject to a lengthy approval and review process by the China Securities Regulatory Commission ("CSRC"), and it could therefore often take months, if not years, to obtain the approval. With the introduction of the STIB, priority is given to high-tech companies involved in strategic sectors, such as the new generation of information technology, new and renewable energy, biotech and advanced equipment. The new exit channel has definitely created a booster effect for the PE and VC investors to seek for China deals.

The robust and highly dynamic stock exchanges in Shenzhen, Shanghai and Hong Kong provided a strong capital markets platform for IPO exits in China. Statistically, all the three China exchanges were ranked amongst the top five, producing IPO proceeds of US$118.7 billion, a 50% increase over the amount produced by the American exchanges. The China market is expected to generate significant IPO proceeds this year, with strong pipelines expected in 2021.

Further, from the regulatory regime, with the Foreign Investment Law and the Implementation Rules ("Foreign Investment Law") coming into effect on January 1, 2020, the process for the establishment of a foreign-invested enterprise ("FIE") was simplified and streamlined. Recently, the setting-up of equity trading centres, such as the Beijing Equity Exchange Co., Ltd., had provided the market with a centralised platform for the facilitation and rendering services for private placements, transfers and related activities of securities for micro, small and medium-sized enterprises within the administrative region of Beijing: https://www.bjotc.cn/aboutus/build.html.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

The devasting effects of the pandemic have brought a huge challenge to all PE investors (including funding solutions); however, China is forecasted to be the only major economy to rebound and is expected to see a positive GDP growth rate in 2021. Some of these postponed PE transactions had resumed quickly and as soon as the COVID-19 pandemic started to be contained; however, cash flows at smaller, privately run businesses have stagnated and caused funding difficulties. With this backdrop, we believe that the Chinese government will continue to promote the reform of the National Equities Exchange and Quotations ("NEEQ"), and make it a main channel to serve small and medium-sized enterprises, science and innovation enterprises, and other private enterprises as a competitive platform for the players to raise new funds.

It is worth highlighting that, based on the recently released Q1 monetary policy report by the People's Bank of China ("PBOC") in May 2021, China remained cautious in formulating its stimulus policies, focusing on ways to address the issue of "*the foundation of our economic recovery is not yet solid*", a core issue that was raised in the Central Economic Work Conference attended by the nation's leaders in December 2020. Domestic consumption is still constrained and investment growth insufficient, in addition to ensuring employment remaining a great challenge. We do foresee that government-backed initiatives would be implemented, boosting larger capital-concentrated mega projects, which would inevitably lead to a corresponding increase in the consummation of PE deals across a wide array of sectors.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

Ultra-high-net-worth individuals and family offices are continuing to build their momentum and cultivating greater appetite towards the PE sphere, either by way of acting as GPs or LPs, or via a conventional approach in making direct investments into the portfolio companies. Apart from that, we are also seeing a greater allocation of funds by the non-traditional PE funds, e.g., sovereign wealth funds and pension funds increasing their portfolios in the China market, extending beyond the money markets/stock exchange, but increasingly acting as lead investors in increasingly PE transactions.

Asia private debt funds have more than doubled from US$28 billion in 2014 to US$64 billion in 2019. These private debt funds are set to accelerate throughout 2021, driven by funding needs for Asia businesses, especially targeting the China market. Due to the withdrawal of government liquidity programmes across the globe, coupled with the tightening in bank lending requirements, as a result, Asia is observing larger and more numerous private credit funds that provide financing solutions.

PE managers and institutional investors are actively increasing their role in providing debt and structured products to corporates, real estate projects and infrastructure developments in China. Private lending has traditionally been driven by banks. However, Asian banks are applying stricter lending standards, making lending more difficult. In addition, as they have been less focused on the small to medium market segments due to credit risk, regulatory concerns and group economics, alternative credit providers are expected to increasingly fill the financing needs of growing Chinese companies in 2021. Private debt solutions are offering China portfolio companies more flexibility, providing investors with higher yields. With a diverse product offering that includes direct lending, mezzanine financing, sponsor lending, and distressed and special situations, private debt is enabling greater and more flexible solutions with respect to traditional bank lending. This solution-based approach, along with the tightening supply, should help drive funds toward the asset class.

2 Structuring Matters

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

The common types of PE transactions in China include mergers and acquisitions ("M&A"), share (equity) transfers and assets purchases. In the case of corporate debt situations, debt-to-equity swaps and debt-plus-equity can also be used for PE investors to convert the debt of the portfolio company that it owned into a certain number of equities based on the corresponding share price.

PE transactions had evolved substantially over the past two decades in China. Basically, there are two broad structures: namely the onshore and offshore investment models. The process of investing in PE in China differs depending on whether the PE fund is an onshore fund or an offshore fund.

Onshore funds

In this type of PE fund, the PE fund invests in an onshore domestic China entity through an offshore special purpose vehicle ("SPV"). The PE firm would then become a direct corporate shareholder in the concerned onshore domestic portfolio company. Subsequently, for an exit via IPO, the listing vehicle is incorporated as an onshore PRC joint-stock company if the PE investors intend to exit by listing the portfolio company on a China stock exchange.

Offshore funds

In this type of PE fund, an SPV acquires or invests in the stocks of the portfolio company's offshore holding company. Often, the holding company holds a 100% interest in a Hong Kong intermediary company, which in turn holds a 100% interest in a China subsidiary. In this type of PE structure, offshore holding companies are commonly called the "red-chip" companies because they hold Chinese assets, be it directly or indirectly.

The 100% interest in the China subsidiary would normally take the form of a "wholly foreign-owned enterprise" ("WFOE"). The offshore holding company is intended to be a listing vehicle if the PE fund intends to exit via IPO outside of China. The offshore investment vehicle is incorporated as a company in a jurisdiction that is offshore (such as the Cayman Islands).

Thereafter, the PE investors in an offshore company exit the holding company after the IPO exercise. However, if the portfolio company is a Chinese domestic entity that does not have an offshore holding company, as a closing condition, PE investors often require the portfolio company to restructure into an offshore structure so that the investors become shareholders of an offshore holding company. The offshore funds model seemed to be the preferred approach for many international PE funds wishing to enter into the Chinese market.

2.2 What are the main drivers for these acquisition structures?

The main drivers for such offshore funds approach would be based upon previous successful precedents, and a tested approach, albeit conventional, it gives the comfort of certainty and predictability. Some other considerations would include tax, speed of closing, flexibility in financing, other requirements and liability issues.

In the event of a share transfer, the need for Chinese authority approval would be minimised as opposed to onshore transaction. However, it is worth highlighting that, should a transfer involve a foreign investment in the equity interests or shares of a Chinese company, approval from the Chinese government would still be required, but as a matter of formality in adhering to the registration-filing requirements.

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

In China, the equity structures commonly used in PE transactions are the share equity investment and mezzanine investment. Considering the regulatory environment for foreign investment in China, many PE transactions would still use the Variable Interest Entities ("VIE") structures to bypass certain regulatory restrictions or limitations for foreign investment in certain types of business, particularly the internet, telecommunications and media and education.

China is increasingly involving and connecting with the global world at large; a series of well thought-out plans to implement its reaching-out initiatives have been successfully implemented and carried out in stages, seeking to create win-win situations in all economic areas. With this backdrop, from its initial centrally planned economy approach, China is slowly and steadily opening its market access to foreign investors and, by allowing so, is learning to embrace and adapt to international practices/norms in PE transactions.

Under normal circumstances, depending on the ticket size, a PE investor will require a seat on the board of the portfolio company and may insist on certain veto rights over certain matters. However, such trends are now shifting; in line with international practices, the scope of exercising such a veto right (over major business decisions) had been limited and reduced substantially over the years, but PE investors are now generally aware of the need to give more freedom to the founding team of the portfolio company in order to allow for more rights to be reserved for the founding team/management.

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

Yes, the minority shareholder will need to have protective provisions clearly spelt out in the shareholders' agreements and the articles of association of the portfolio company. Among other considerations, the following are usually included, e.g.: (i) founders of portfolio companies shall be entitled to transfer the equity of the company directly or indirectly owned by them only upon obtaining the prior written consent from the minority shareholder; (ii) entitlement to a board seat (which depends on the negotiation outcome); (iii) veto rights over certain major matters that affect the rights or interests; and (iv) provisions on investor rights and privileges, including but not limited to rights to access to information and inspection, and pre-emptive, first refusal, tag/drag-along, dividend preferential, liquidation, redemption, anti-dilution and registration 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?

There is no specific range; typically, this could range from 5–25% of equity allocated to the management, and it is often tied to the terms of the employment of the key personnel.

As for the vesting period, key founders are expected to stay for a further two to three years post-acquisition. Generally, 50% of the founders deal consideration would be offered, comprising a combination of stay bonuses, re-vesting, escrow provisions, earn-outs, revenue milestones, and giving out 'carrots' such as new equity grants, cash retention bonuses, etc.

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 bad leavers if their employment is terminated due to breach of contract, fraud, wilful misconduct, or engaging in other unethical activities, etc.

Good leavers, on the other hand, may generally refer to the management equity holders' resignation with valid and good reason after a specified period of time, thus not leaving the company in a bad shape and through early termination due to death or disability, or upon 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?

China's corporate governance rules are generally incorporated in the Company Law of the PRC ("Company Law"), with additional rules supplied by specific regulations governing the conduct of public listed companies and FIEs.

Unlike many other countries where the board of directors normally welds most power in corporate governance, the ultimate managing power in China is allocated differently according to the types of company. In domestic limited liability companies, companies limited by shares (either listed or unlisted) and WFOE, the general meeting of shareholders is entitled to make decisions on all matters of importance, leaving the board with daily management and execution of the shareholders' decision, in light of the highest authority of a company vesting with the shareholders.

Be that as it may, governance arrangements among PE investors and management will, in most cases, be spelt out in the form of a shareholders' agreement or relevant transaction documents, which are not generally required to be made publicly available. However, in some situations, if such governance matters are reflected in the articles of association of the portfolio company, such constitutional document would then have to be lodged with the government authority, hence rendering it accessible to public.

If a PE investor only invests a minority stake but is substantial enough in the portfolio company, it is advisable for the PE investor to fight for a seat of at least a financial controller, which can be pushed further. A position as a VP in an operational role in the founder-controlled operating company would give the investor the monitoring/supervisory right to monitor the company's operations and, to a great extent, the right to a say in its expenditure. Again, it would still depend on what type of value-added contribution a PE investor may bring with them, apart from providing funding. With the massive market opportunity for scalability, the founding members of the operating company seem to have an increasing amount of bargaining power; in short, we are seeing a "seller's market" in China right now.

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, such veto rights will be vested in the form of either a shareholder's veto or director's veto (in the event a director seat is granted. Typically, such rights will be spelt out under reserved matters and usually include: amendments to articles of association; change of business scope; share transfers; capitalisation of the company; liquidation or dissolution of the portfolio company; indebtedness; and any other matters that may have any material impact on the company, from management operations to financial performance, 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 veto rights to the shareholder or director are protected by the Company Law so long as such rights have been stipulated in the articles of association of the portfolio company upon the unanimous consent of the shareholders and are not in violation of the prohibitive provision of the laws and regulations.

It is worth mentioning that since the promulgation of the Foreign Investment Law, the highest authority of a company in China now vests with the shareholders, instead of the previous laws and regulations governing foreign investment, e.g., the Sino-Foreign Equity Joint Venture Law/Regulations (now repealed), which expressly stated that the highest authority of a company shall be the board of 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?

Pursuant to the Company Law, shareholders of a company shall exercise shareholders' rights in accordance with the provisions of laws and administrative regulations, as well as the articles of association of the company. PE investors shall not abuse their shareholders' rights to cause damage to the portfolio company or the interests of other shareholders, including but not limited to the majority shareholders, or abuse its rights to prevent or interfere with dividends, resulting in losses to other 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)?

Onshore transactions: PRC law shall be the governing law in the case of an onshore transaction, meaning that if a foreign PE investor invests into or acquires equity interests in a PRC portfolio company, it shall be subject to government approval and the share purchase agreement and shareholders' agreements shall be governed by PRC law.

Offshore transactions: In the case of an offshore transaction, shareholders' agreements are normally governed by the law of the jurisdiction of the offshore company, whilst a subscription agreement may be governed by a different law of choice to be agreed upon by the parties.

Arbitration clauses have been the norm, for both onshore or offshore transactions for the settlement of disputes. The seat of arbitration can be freely chosen by the parties, but it ought to be agreed upon and expressly provided in the agreements. It is not difficult to understand that, when given a choice, the founders of portfolio company would prefer to have a China-based arbitration tribunal, while a foreign PE investor may prefer a more neutral seat. Parties will often come to a compromise and accept to have such seat in either the Hong Kong International Arbitration Centre ("HKIAC") or Singapore International Arbitration Centre ("SIAC").

In the case of non-compete and non-solicitation provisions, there is no express provision under PRC law with regard to limitations or restrictions on the contents or enforceability of shareholders' agreements; however, these are always subject to the fundamental principles of not violating the national security interests of China.

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?

Article 146 of the Company Law provides the qualifications and duties of directors, supervisors and senior officers of a Chinese company. Nominees who fall under the following situations shall not be eligible to be appointed to the boards: (i) any person who does not have civil capacity or who has limited civil capacity; (ii) any person who has been convicted of any criminal offence in the nature of corruption, bribery, disseizing, misappropriation or disrupting the economic order of the socialist market, and five years have not elapsed since any penalty imposed has been completed; any person who has ever been deprived of his political rights due to any crime, and five years have not elapsed since the penalty imposed was completed; (iii) any former director, factory director or manager of a company or enterprise that has been declared bankrupt and liquidated, in circumstances where he was personally responsible for the bankruptcy of the company or enterprise, and three years have not elapsed since the bankruptcy and liquidation of the company or enterprise was completed; (iv) any former legal representative of a company or enterprise that has had its business licence revoked and has been ordered to close its business operations due to a violation of law, in circumstances where the former legal representative was personally liable for the revocation of the business licence and three years have not elapsed since the date of revocation; or (v) any person who has significant unpaid due debts.

Under PRC law, the legal representative (normally, the chairman) has the obligations to act on behalf of the portfolio company, including, but not limited to, execution of legal documents, cooperating in administrative or civil/criminal investigations undertaken by government authorities, appearing in court, etc., and, in civil cases, the plaintiff may apply to the court for a restrictive order to prohibit the legal representative from leaving China pending completion of the litigation matter or debts being fully repaid. Therefore, PE investors shall be careful in nominating such a person to the board, and particularly, acting as the legal representative.

In addition, with the tightening and enhancing measures adopted by the CSRC, in the spirit of curbing corruption practices and governance aspects, a series of practice notes were issued. One recent added requirement is the imposition of a higher burden and the responsibility on the directors, supervisors and senior officers of the company to provide his/her personal banking statement for the last few years to the authority for IPO submission.

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?

Generally, directors bear fiduciary duties toward the portfolio company in accordance with the Company Law. Without obtaining the consent of the board of shareholders or a shareholders' general meeting, directors shall not abuse his/her duties and powers to seize commercial opportunities of the company for himself/herself or others or engage in similar business as the companies on his/her own or with others.

Recusal or abstention in the boards are expected, especially in public listed companies, where a member of the board is deemed to be 'related to' a particular motion, resulting in potential direct or indirect conflict of interest. In other instances that may involve transactional conflict, full and frank disclosure to the board prior to entering into discussion would be a prudent exercise. Although there is no strict legal guidance *per se*, internal corporate governance would normally spell out the situation where a conflict of interest may take place, as well as the procedures to deal with such occurrences.

4 Transaction Terms: General

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

The timeline of PE transactions is often impacted by the due diligence process, negotiation of definitive documentation, obtaining debt financing, third-party consents and regulatory approvals. Cultural differences would also sometimes materially impact the transaction process.

Onshore transactions: approvals from the Ministry of Commerce ("MOFCOM") are required prior to closing, followed by the registration-filing process with the State Administration for Market Regulation ("SAMR"). Materials including transaction documents, share purchase agreements, articles of association and other supporting documents also need to be submitted. The process for such approval process had arguably been made simpler with a shorter timeframe, after the implementation of the Foreign Investment Law. It is to be noted that although bilingual documents are quite often executed, for submission purposes, usually only the Chinese version is required to be lodged. Therefore, the drafting of the bilingual documents ought to be carried out by professionals instead of relying on outsourced translation companies, in order to prevent misunderstanding of the terms and conditions or the possibility of having a lost-in-translation scenario.

Although it is rare to see PE deals having to trigger merger-filing obligations under the Anti-Monopoly Law of the PRC ("AML"), in the event they are needed, the timeframe would indefinitely be prolonged substantially. In China, the test to determine whether a filing pursuant to the AML is required would consist of two factors: (i) the change of control test; and (ii) the turnover threshold.

Change of control: merger filing is required if: (i) one acquires control over the other; or (ii) there is a possibility of exercising decisive impact on other undertakings by virtue of acquiring their equities or assets, either by way of contractual arrangements or by other means. In most PE deals, however, minority interest may be acquired, although this does not necessarily mean the PE investor does not have control over the target under the AML.

Turnover threshold: this shall be met if: during the previous fiscal year, the total global turnover of all undertakings participating in the concentration exceeded RMB10 billion, and at least two of these undertakings each had a turnover of more than RMB400 million within China; or during the previous fiscal year, the total turnover within China of all the undertakings participating in the concentration had exceeded RMB2 billion, and at least two of these undertakings each had a turnover of more than RMB400 million that occurs within China. Great attention must be paid to the turnover threshold so that even if a concentration of undertakings does not trigger the turnover threshold, should the facts and evidence collected indicate that the concentration has or may have the effect of eliminating or restricting competition, the AML enforcement agency under the State Council may carry out investigations.

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

As mentioned earlier, with the availability of liquidity globally seeking to pump into the Asian region, especially in the midst of this pandemic with a lot of uncertainty, PE funds are chasing after deals in China in an ever more aggressive manner. This has created intense competition among PE investors, giving rise to founders of portfolio companies having more bargaining power in negotiating more favourable transaction terms with higher valuation with their potential prospective investor.

Due to over-expansion with high gearing and huge liabilities, and the inability to honour the repayment deadlines to their financial creditors, we are witnessing quite a number of such reputable and large market-capped Chinese companies seeking massive bailouts from white knight rescue missions, particularly so from deep-pocketed PE investors via restructuring processes to avoid liquidation leading to bankruptcy. These types of deals involve highly sophisticated negotiations, but 'beggars can't be choosers' and PE investors tend to have an upper hand in such deals. Such distressed assets have the potential to be good if they can be strategised, with turnaround by professional players, and could be regarded as good bargain deals if the exit timeframe is set to be a mid- to long-term investment type.

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 China, insofar as PE transactions are concerned, leveraged buyouts and going-private transactions are not entirely common to date. Owing to China's examination and approval regime for IPO exercise (with the exception of the recently implemented STIB alternative), a company that has fulfilled the criteria and credentials in order to be approved for listing is itself a huge accomplishment.

However, in the past two to three years in particular, and with the escalation of geopolitical tension between China and the US, we are seeing more and more Chinese-controlled overseas listed companies' privatisation processes, where they are seeking going-private transactions and exploring relisting options either in the Shanghai or Shenzhen Stock Exchange, or the Hong Kong Stock Exchange.

With the recently public statement (July 30, 2021) issued by the Chairman of US Securities and Exchange Commission, additional disclosures are now required from Chinese companies seeking a listing on US stock exchanges. This may be viewed as a counter measure by the US side, following Beijing's recent crackdown on a few Chinese companies in their overseas IPO, citing cybersecurity concerns; against this backdrop, we do foresee there will be a mass exodus of China-based companies from the US stock exchanges.

Generally, barring political reasons, the main reason for an overseas public listed company to convert the public-to-private status in a particular stock exchange abroad, with the help of PE investors, is often the intention to seek for future listing in another stock exchange for higher valuation and to attract more liquidity. Such exercise would normally involve applicable takeover codes in which the said entity is listed, and overseas counsel would then need to play a leading role.

Among the challenges faced are compliance with the requirements of the particular stock exchange, uncertainty from the public shareholders, timeframe, and reputational risks at the public sphere.

A common way to deal with such challenges is by way of consulting with the local stock exchanges and the relevant regulatory authorities for a clearer timeframe, entering into an agreement with existing major/substantial shareholders who could help secure the required number of votes to support the proposed going-private exercise, and having in place a good investors-relations communication mechanism.

In the event that such going-private exercise is backed by the intent for listing exercise in the domestic market, the PRC counsel would need to play a significant role, as soon as practicable, in the restructuring process to convert the entity into an onshore company fitting the criteria for domestic IPO.

In China, such going-private exercise is undertaken pursuant to the Administrative Measures for the Takeover of Listed Companies (revised in 2020) ("Takeover Measures"), along with other securities-related laws and regulations and bylaws issued by the CSRC. Some of the key considerations are to examine the acquirer's qualification and suitability, creditworthiness, acquisition intent, and terms of offer, and the need to appoint an independent financial consultant for an expert opinion. The board then has a duty to make public on such an expert opinion, giving the shareholders the opportunity to decide whether or not to accept the offer. Certain *status quo* terms are expected during the period of the tender offer, e.g. the directors shall not resign, and without the approval of a shareholders' general meeting, the directors shall not dispose the company assets, make external investments, make adjustments to the principal business of the company, or provide guarantees or loans, etc, which will have a significant impact on the assets, liabilities, equities or business results of the company.

In the situation that a management buyout offer was made, the public listed company shall have a proper and well-functioning organisational structure and an effective internal control system, and the ratio of independent directors in the board of directors of the company shall attain or exceed 1:2.

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

It is common for a PE investor to add an exclusivity clause to restrain the seller from looking for other buyers upon signing the definitive agreement. In addition, break-up fees are also acceptable under PRC law and can be seen in PE deals, e.g. legal and financial due diligence-related costs, which range between approximately 1–1.5% of the equity 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?

Apart from the normal provisions of a share purchase agreement in private acquisitions, certain provisions are specific to general PE transactions.

Buy-side

(i) Valuation and readjustment: it is advisable to take valuation and readjustment arrangement into consideration and for this to be reflected in the share purchase agreement, in order to minimise the loss suffered by the buyer due to the shortfall between the agreed purchase price and the actual market.

(ii) State Administration of Foreign Exchange ("SAFE"): specific representations related to compliance with the rules by SAFE ought to be expressly spelt out. As foreign exchange is heavily controlled in China, any transactions involving foreign currency cross-border remittances would require for SAFE approval to be obtained as a condition precedent prior to closing. This is important as it would impact the future repatriation of profits or dividends (if any) in the future.

(iii) Breaches and Indemnifications: PE investors may negotiate for special breach remedies and indemnifications in the event of a breach, taking into account commercial negotiation considerations. If such remedies or indemnifications are subject to PRC law, and are punitive in nature, the burden of proof shall vest on the claimant for such losses and hence requesting the court or arbitration to support such actual or foreseeable losses may not be easily recognised.

Sell-side

Representations and Warranties: PE investors may want to limit such representations and warranties in the agreements, to keep it to a bare minimum (see question 6.2 below).

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

Depending on the strength of negotiation, under normal circumstances, if a PE is on the seller-side, representations and warranties are expected to undertake post-closing indemnifications for breaches of such representations and warranties. Payment terms related to the transactions may also need to be extended (e.g., last escrow payment is not made until, possibly, 12–24 months after the initial closing) in order to cover any unexpected/contingency liabilities revealed post-closing. In addition to the covenants in the transaction documents, confirmation letters on some significant facts and key issues ought to be delivered to the sellers to reduce the risks that may arise out of the 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?

Non-compete and non-solicitation undertakings are crucial and such provisions are typically used in venture capital investments for start-ups, although, to a great extent, they also apply to PE investments. The founders of the portfolio company, along with his/her team members, are the most valuable resource in any company, so as to ensure the continued survival and growth of the portfolio company, PE investors must secure full-time and exclusive services of the core team (key management) for an agreed period or a KPI to be installed, ensuring that they would collectively drive the company to achieve a specific milestone.

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?

Representations and warranties insurance is not commonly used in China PE deals but has seen some in deals, particularly foreign investments in sophisticated, larger deals, with a premium ranging from 1.5–3% depending on the deal size, industry type and jurisdiction involved.

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 would normally survive for a period of 12–24 months post-closing, although this again depends on the negotiation power of the parties; whilst a buyer would wish for it to extend for as long a period as possible, the seller, on the other hand, would want it to keep the R&W to the shortest possible term. Seller's counsel will often request to cap the amount for indemnification (typically between 5–15%), along with a survival period of the representations and warranties, such as six to 12 months post-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)?

There is no actual statistical survey conducted in this aspect for China PE deals – it would vary on case-by-case basis and also depends on whether it is a buyer or seller's market.

A PE buyer may insist on opening an escrow account or for a joint management account to be set up, and request the seller to deposit a certain amount (usually between 10% and 15% of the total purchase price) as a recourse to cover indemnification for representations and warranties breaches to cover the losses and damages, whilst a PE seller would not provide any sort of additional security other than the mentioned escrow amount (if at all agreed to).

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 buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

The PE seller will typically request a corporate guarantee delivered by the parent company of the buyer, under which it irrevocably and unconditionally guarantees to pay the PE seller all amounts so as to ensure that the seller ultimately receives the purchase price in full.

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 China PE deals. However, PE investors may request an exclusivity clause in the term sheet. In the event of breaching such an exclusivity clause, PE buyers can then assert claims for damages, normally capped at the professional fees and expenses incurred, such as legal and financial due diligence costs.

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?

One of the common exit strategies for PE firms is to seek for an IPO. As the approval process for a portfolio company via an IPO in the main board market is strict, time-consuming and arguably costly, coupled with rather a long queue in the pipeline, many PE firms now may opt for the NEEQ or the STIB, both of which are for small and medium-sized companies, with neither being limited to high-tech industries and there being no restriction on the nature of shareholders' ownership. Nevertheless, the frenzy and enthusiasm to float via the NEEQ has seen a significant drop in share prices in the past one to two years because of its low levels of trading and a move towards the STIB. According to Zero2IPO Research, in 2020, there were among 145 listed companies on the STIB, 114 of which have gained support from VC/PE investors, and the STIB has become the preferred exit channel for investment institutions.

Be that as it may, the government will continue to promote the reform of the NEEQ so that private enterprises, small and micro enterprises, and science and technology innovation enterprises can obtain more financing through the capital market and promote equity investment to have more exit channels.

The financial performance of the company, size and scalability, industrial sector and growth potential, compliance-related issues, the time required for the preparation, and approval for the IPO are amongst the important considerations.

It is worth noting that two mega IPOs were faced with setbacks: firstly, Ant group, which was supposed to be the world's largest IPO at the Shanghai Stock Exchange, expected to raise an estimated US$37 billion and boost Ant's market value in excess of US$300 billion (as of November 2020), but was halted at the very last minute. Secondly, although the ride-hailing app DiDi, which had its IPO at the New York Stock Exchange on June 30, 2021, successfully raised US$4.4 billion, giving it a market value of around US$68 billion, the shares have since plummeted over 40% below their IPO price as of July 26, 2021. DiDi has since been in trouble with the Chinese government authority, with a series of investigations and questioning over its compliance issues (allegedly, issues pertaining to national security interest), and the spill-over effect that had impacted DiDi-related/funded mobile apps (25 of it altogether), which had been requested to be removed in the China market. With this backdrop, it is worth noting that, apart from being able to fulfil the listing criteria in an overseas market, prior communications and approvals with the relevant Chinese government authorities ought to be treated with utmost case and seriousness in light of these precedents.

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

Pursuant to the Company Law, shares issued by the company before the share offering shall not be transferred within one year from the date on which the shares of the company are listed on a stock exchange. The period can be shorter if the IPO takes places abroad; this depends on the rules by 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?

It is not uncommon for PE sellers to adopt a dual-track strategy as this can turbocharge the exit and offer investors greater return. PE sellers may map out a wide variety of exit strategies based on the complexity and cost of two tracks, market conditions, and resources available, as well as sponsor motivations and other considerations.

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).

In China, PE transactions involving large-scale financing are funded by commercial banks. For other smaller deals, using bridging loans to provide short-term cash flow for the portfolio company during negotiation seems to be the norm.

The Company Law imposes restrictions on companies and management when granting security for debt financing. Specifically, where a company invests in other enterprises or provides guarantee for others, a resolution passed by the board of directors, board of shareholders or a general meeting in accordance with the articles of association of the company shall be required. Where the articles of association of the company provide a limit for the total amount of such investment or guarantee or the amount of each investment or guarantee, such limits shall not be exceeded. In the case of a company providing guarantee for a shareholder or the actual controlling party of the company, a resolution passed by the board of shareholders or a general meeting is required. Shareholders stipulated in the preceding paragraph or shareholders controlled by the actual controlling party stipulated in the preceding paragraph shall not participate in the resolution in respect of the matter stipulated in the preceding paragraph. Such a resolution shall be passed by a simple majority of votes cast by other shareholders attending the meeting.

A third-party guarantee will commonly need to be provided upon the occurrence of the large-scale debt financing. For offshore transactions, SAFE rules expressly prohibit an onshore guarantee to an offshore entity where the debt finance is used to acquire another offshore company's equity, and 50% or more of the assets of such portfolio company are located within China.

China still has a broader set of actors and structures dominating the PE space. In China, funding for PE deals could also come from a plethora of conglomerates and holding companies, as well as from the government, from big SOEs or directly from state-backed PE firms. Other channels for debt financing could also be provided by licensed trust investment companies, via raising unit trust plans/funds to the public, and licensed assets management companies could also raise funds from the public or utilise their own funds and, in turn, lend the funds raised to PE investors. In addition, investors who meet the condition can also use a Qualified Domestic Limited Partner ("QDLP"), a Qualified Foreign Limited Partner ("QFLP"), RMB investment and loan funds and other capital channels.

In view of the higher lending costs with significantly higher entry barriers, high-yield bonds are not a common source of debt financing for PE deals in China.

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 may have certain limitations on the amount and period of different types of debt financing, which need to be taken into consideration. For instance, with respect to the onshore debt financing, if a domestic acquirer applies for an M&A loan from the commercial bank, the amount of such loan shall not exceed 60% of the total transaction amount and the term shall not exceed seven years. As for offshore debt financing, such terms shall be subject to local law or jurisdiction given that the financial institutions are usually outside the territory of the PRC.

The CSRC released the Several Provisions on Strengthening the Regulation of Privately Offered Investment Funds in December 2020, which further regulate the business activities of privately offered investment funds. In particular, the administrator of a privately offered fund shall not directly or indirectly use the property of the privately offered fund in: borrowings (deposits) and loans; guarantees; equity in the nature of debts; and other non-privately offered fund investment activities, except where the privately offered fund provides loans and guarantees with a term of not more than one year for investee enterprises, pursuant to the contractual agreement for the purpose of equity investment, and such loan or guarantee balance shall not exceed 20% of the paid-up amount of the said privately offered fund.

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

At present, the market's view towards China's monetary policy in the second half of the year is generally to maintain neutral as the benchmark; although some participants expect policy easing, this has not become the mainstream view in the market. Recently, the executive meeting of the State Council decided to increase financial support for the real economy and introduce measures to further support carbon emissions reduction. The meeting called for timely use of monetary policy tools, such as reserve requirement reduction to further strengthen financial support for the real economy, especially for micro, small and medium-sized enterprises. In our opinion, lowering the reserve requirement ratio of commercial banks can release long-term liquidity, help strengthen the capital strength of banks, guide them to lend to enterprises at more favourable interest rates, especially micro, small and medium-sized enterprises, and help enterprises reduce financing costs.

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?

Enterprise income tax ("EIT") is one of the key considerations for PE transactions in China. At present, EIT is set at 25% for all resident companies, with 20% being the capital gains tax for non-resident companies, based on the profit derived from disposing of equity in domestic companies or other assets, such as real estate or land-use rights as withholding income tax.

With regard to offshore transactions, according to a circular relating to EIT on the transfer of assets between non-resident enterprises issued by the State Administration of Taxation ("SAT") in February 2015, "where a non-resident enterprise makes indirect transfer of assets such as the equity of a Chinese resident enterprise through arrangements which do not have a reasonable commercial objective to circumvent the EIT payment obligation, the indirect transfer shall be redefined pursuant to the EIT as direct transfer of assets such as equity of Chinese resident enterprises". PE investors should pay attention to such requirements when designing investment and transaction structures as well as exit plans.

In respect of individuals, interests, dividends, bonuses received and income from the transfer of shares or other rights are subject to a 20% individual income tax ("IIT"), while income from wages and salary is subject to progressive tax rates ranging from 3% to 45%.

Stamp duty of 0.1% (based on the total consideration) is also applicable in PE transactions; such rate shall remain unchanged in the forthcoming Stamp Duty Law, which is set to take effect from July 2022.

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)?

Implementing an equity-based compensation scheme, such as growth shares and incentive shares for the management teams or, in some circumstances, employees of the portfolio companies in China is challenging, and can be deemed a costly undertaking. In respect of the use of such granting options, although not uncommon, the tax-efficient arrangements are yet to be seen, mainly because the laws and regulations, to the extent applicable, do not specifically address certain issues and/or are ambiguous and often incompatible with more mature markets such as in Europe or the US. Share options granted in China will be subject to tax upon exercise under PRC law. There is yet to be any sort of favourable tax treatment in China. To complicate the situation further, the CSRC has indicated that new regulations are forthcoming and has advised certain law firms to counsel their clients against implementing any type of stock options until the final rules are issued.

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 indirect transfer of assets, such as the transfer of equity of Chinese resident enterprises by non-resident enterprises, without a reasonable commercial purpose, shall be subject to EIT (see question 9.1).

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?

At a macro level, PRC authority aims to improve tax mechanisms in accordance with the development of its domestic economy condition, with a certain flexibility on a provincial level for types of tax-preferential treatment given to specific industries or types of investments. The main aim is to continuously attract long-term capital investments in China.

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 is an overall tightening trend in regulation aspects in PE transactions, in which a series of regulatory policies have been released from December 2020 to June 2021, such as the Several Provisions on Strengthening the Regulation of Privately Offered Investment Funds, the Guidelines on the Application of Regulatory Rules – Disclosure of Information on Shareholders of Enterprises Applying for Initial Public Offering, etc., focusing on strengthening self-regulation administration and risk monitoring.

The Several Provisions on Strengthening the Regulation of Privately Offered Investment Funds stipulates 10 activities that privately offered fund administrators, privately offered fund trustees and other offered fund service providers and their employees are prohibited to conduct, such as engaging in affiliated transactions that harm the privately offered fund property or the interests of investors, directly or indirectly using the property of the privately offered fund in the investment activities with unlimited liability, or for other certain investment activities.

Guidelines on the Application of Regulatory Rules – Disclosure of Information on Shareholders of Enterprises Applying for Initial Public Offering further increase the intermediary's responsibilities, reinforce the penetration inspection of shareholders, focus on verification of improper tunnelling, shareholding entrustment and other violation behaviours. Furthermore, where an issuer adds new shareholders within the 12-month period preceding submission of an application, the new shareholders shall undertake that the new shares held by them will not be transferred within 36 months from the date of acquisition.

Significant legislation and guidance adopted in the past two years relating to the security review on foreign investment and investment and financing for addressing climate change may have an impact on PE portfolios.

The Measures for the Security Review of Foreign Investments promulgated jointly by the National Development and Reform Commission ("NDRC") and MOFCOM started to take effect in January 2021. Foreign investments, either through new projects or acquiring equity or assets of domestic enterprises by way of M&A, that affect or may affect national security are now subject to security review by the working mechanism office of the NDRC.

In addition, increased attention must be paid to potential climate change concern, particularly as China has constantly promoted investment and financing actions in climate change in recent years. In October 2020, the Ministry of Ecology and Environment issued the Guidance on Promoting Investment and Financing in Addressing Climate Change, further emphasising the supporting role of investment and financing in addressing climate change and stating that standards for climate projects, climate information disclosure and climate performance evaluation will be developed in the future. PE investors should be aware that low-carbon transition might increase legal and compliance costs and risks for traditional high-carbon industries and special consideration should be given to this in due diligence.

Last but not least, in terms of improving exit channels, the CSRC has released the Special Provisions on Reduction in Shareholding by Venture Capital Fund Shareholders of Listed Companies in March 2020, further simplifying the criteria for applying the "reverse link" policy (which means that the lock-up period of the shares invested by venture capital funds is inversely proportional to the investment period; that is, the longer the investment time, the shorter the lock-up period). This requires that investors applying for the "reverse link" policy should meet the requirements of "early investment", "medium and small investment" or "high-tech investment". There are, however, no further restrictions on the proportion of total investment and the restriction on the reduction of venture capital funds of over five years will be cancelled.

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 of foreign investments that are deemed to be sensitive from a national security perspective. Pursuant to the Measures for the Security Review of Foreign Investments as stated in question 10.1, foreign investments within military industries or relating to the security of national defence, or in important agricultural products, important energy and resources, important equipment manufacturing, important infrastructure, important transport services, important cultural products and services, important information technology and internet products and services, important financial services, key technologies and other important fields relating to national security, and obtaining the actual controlling stake in the investee enterprise, are subject to pre-declaration to the office of the working mechanism prior to the implementation of the investments.

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 timeline and scope of legal due diligence in connection with PE deal activity varies from case to case, in particular depending on the transaction size, the nature and operation status of the portfolio company, and other important factors. Generally, law firms will conduct legal due diligence through on-site investigation, reviewing documents provided by the portfolio company, as well as publicly available information and materials disclosed on government official platforms, and will then provide the legal due diligence report covering the following aspects: corporate; assets; material contracts; employment; intellectual property; litigation; and compliance status of the portfolio company. Beyond the general matters mentioned above, the scope of the legal due diligence generally also depends on the exact needs of the PE investors, combined with key concerns of specific industry involved.

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.)?

So far, there is no formal unified anti-bribery law or anti-corruption law or code in China. The relevant contents are mainly concentrated in the Criminal Law of the People's Republic of China, the Law of the People's Republic of China Against Unfair Competition, and administrative aspects laws and regulations. In recent years, the anti-corruption efforts have been intensified, which have a heavy effect on the PE investments activities. The inspections and investigations are geared towards corruption among government officials and leaders of SOEs in equity investments, to prohibit the aforementioned personnel from improper channelling or buying shares at low prices (insider's information), etc.

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?

Not to our knowledge. PE investors will most commonly be LPs, which are only liable for the debts of the partnership enterprise up to their subscribed capital contribution. However, where a third party has reason to believe that an LP is a GP and enters into a transaction with the partner, such LP will be liable in the same manner as a GP in the transaction, which shall be jointly and severally liable without limit for the debts of the partnership enterprise, in accordance with the Partnership Enterprise Law of the PRC.

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?

China has been constantly enhancing the environment for foreign investment and deepening reform and opening up. It has been over six years since the implementation of the Securities Investment Fund Law of the PRC in 2015, during which a series of supporting rules and measures have been carried out so as to further lay the institutional and regulatory foundations in PE transactions. There are tremendous long-term opportunities in PE deals within China in view of the continuing development of the Chinese PE market and the strong support and priority on growth by the Chinese government.

Open, transparent, flexible and legally protected financial and commercial markets would definitely help to drive PE transactions and expedite decision-making processes. We firmly believe that China will maintain an open door for PE transactions, especially for cross-border investment.

PE investors, particularly foreign investors, should be aware that there are still several fields, involving human stem cells and gene diagnosis and treatment technologies, pre-school education, ordinary high school and higher education institutions, internet news services, internet publishing services, etc., that are explicitly prohibited or have special requirements on foreign investment access, such as equity requirements and senior management personnel requirements. Attention must be given to these "investment negative list" concerns, particularly given the implementation of a national security review.

Will Fung, with his outstanding professional experience in the legal practice in China, has joined the first batch of foreign legal counsels duly registered with the Beijing Municipal Bureau of Justice. He is also a frequent guest and speaker for ASEAN "Belt & Road Initiative"-related investment forums. Specialising in cross-border M&A, PE/VC, and foreign direct investment in China, Mr. Fung is noted by sources for his good commercial awareness and being a skilled negotiator with a track record in delivering flexible and creative solutions for his clients.

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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?

Throughout the past years, the private equity market has continued to grow in France and this trend has not been impacted by the COVID-19 crisis (although certain deals were halted during the first months of the pandemic). The private equity market has been quite active in all segments and has shown excellent performance. We also notice a marked interest in companies specialising in 'resilient' sectors, such as health, science and technology. This is particularly true in the venture capital market, which has played a major role in providing concrete and innovative solutions during the COVID-19 crisis, but is also true for the private equity sector through buy-and-build transactions. This trend is also present in the growth, buy-out and turnaround capital markets.

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

In recent years, various legal reforms have been put in place to strengthen France's attractiveness and ambition to become a central player in the private equity market in Europe, especially following Brexit. These reforms have had a direct consequence in increasing investors' interest in French companies and, more particularly, for foreign investors' growing perception and confidence in the French market.

These include, for instance: (i) the progressive decrease of the corporate tax rate; (ii) very attractive research and development tax credits (CIR); (iii) important reforms to labour law to provide a relative certainty with regard to the indemnities for dismissal without real and serious cause; (iv) the entry into force of the Loi PACTE, which simplified the use of preferential shares and BSPCEs to name a few; or (v) tax advantages attached to investment (such as income tax credit or exemption), which remain an essential and determining element of investor's interest in French companies.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

It is quite difficult to predict the long-term effects of the crisis on private equity. During the early months of the pandemic, the flow of transactions was significantly reduced and even halted where the deals were not advanced enough. Companies have attempted to secure their cash flow and obtain bank loans. Right from the start of the COVID-19 crisis, the French government, as well as the European Commission have implemented important economic stimulus plans. For instance, most French companies were able to benefit from the French government financial aid set up to help companies face the crisis under the *Prêt Garanti par l'Etat* (PGE) programme and the postponement of payments of tax and social security charges. On the other hand, investors have focused on securing their existing portfolio companies and, where necessary, have re-injected funds into them. A significant number of management packages had to be renegotiated in order to maintain the incentives, and plans to sell portfolio companies have been delayed.

Today, although the economic environment is still uncertain, the private equity market is on the rise, with a high dry-powder level and increasing valuation multiples.

Companies, heavily indebted, are now seeking to strengthen their equity but also need to adapt their sectors towards digital transformation, which were fastened by the pandemic.

Challenges for investors are twofold: rightly choose their target companies and position themselves to finance such companies, but also obtain an interesting ROI based on the current increase of valuation multiples.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

We note that end investors are interested in giving meaning to their investments and financing projects that do not only provide a positive financial return but also have a positive social, environmental or societal impact. Various institutional investors have growing demands for strong Corporate Social Responsibility ("CSR") commitments from their portfolio and have integrated these elements into their standards. This trend is expected to intensify as demonstrated by the success of impact funds, which specifically seek to implement investments that generate a measurable, beneficial social and/or environmental impact, in addition to a financial return (for instance, job creation in specific geographical areas, waste minimisation).

2 Structuring Matters

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

It is important to note the difference between the private equity vehicle and the actual structure that will control the various investments carried out by the private equity fund.

As such, usually the structure that controls the private equity fund is put in place through a simplified joint-stock corporation (SAS), although joint-stock corporations (SA) are also used in some other cases. The said company's activities fall under the supervisory powers of the French *Autorité des marchés*.

As for the actual private equity investment activities, this is put in place through various investments funds: the *fonds professionnel de capital investissement*; the *fonds professionnel spécialisé*; and sometimes even as *société de libre partenariat* (its equivalent being the limited partnership vehicle under common law jurisdictions).

In some other cases, there can also be other holding companies between the actual controlling investment structure and the fund. For instance, where management packages are put in place.

2.2 What are the main drivers for these acquisition structures?

Financial considerations are the main driver for these acquisition structures, together with guidelines for investments purposes to collect higher ROIs. Fiscal considerations will also be considered (favourable tax system and exemptions on capital gains). It is also important to note that the *fonds professionnel de capital investissement*, the *fonds professionnel spécialisé* and the *société de libre partenariat* are not subject to corporate income tax but the actual investors within the said funds are subject to personal or corporate income tax.

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

Usually, private equity funds will raise investment funding through equity, debt or other non-equity source of financing to invest within chosen targets. Fund Managers receive income on fees and carried interest shares through waterfall provisions. It is also important to note that there are specific rules put in place by the *Autorité des marchés financiers* and specific sets of rules guide the conduct of funds together with various other ethical obligations.

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

The various structuring considerations will depend on the provisions of the articles of association or the shareholders' agreement.

It is also important to note that, under French law, articles of association filed at the *Registre du commerce et des sociétés* (the commercial registry) are thus public and opposable to all third parties. However, shareholders' agreements remain confidential and thus not opposable to third parties.

Under French law, certain decisions require a unanimous decision. As such, both the articles of association and the shareholders' agreement may offer certain protection for private equity investors taking a minority position. These can be sought for through specific dispositions with regard to governance rights (a representative in the supervisory board level that will not interfere in the daily management of the company or, instead of a representative, a member acting as an observer), prior approval, and veto rights on any decision that may have an impact on the investment made by the private equity investor. These same sets of dispositions may be completed in the shareholders' agreement. Classic tag-along rights are also usually included in the shareholders' agreement.

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 equity allocated to the management usually ranges from 10% to 15%. The analysis to structure each management package should be made with good care and in relation to the compensation and tax issues. Free shares can be interesting but cannot represent more than 10% of the outstanding share capital of the issuing company. These shares are allocated to the managers and can either be ordinary or preferred shares. It is also interesting to note that BSPCEs are privileged in venture capital since they are not subject to this limitation. Sweet equity packages can also be implemented, which consist of having the managers invest only in the capital while the private equity investor will primarily invest in convertible bonds. This scheme offers the management a higher portion of the share capital. Specific care should be taken when drafting the value of the ratchet shares and more specifically with regard to tax impacts and the requalification of such package as part of the management salary.

The management package also contains good and bad leaver clauses and specific call options, as well as specific drag-along rights to the majority 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?

The objective of these good or bad leaver clauses is twofold: maintain the management within the company during a certain period of time and organise the transfer of their shares. These clauses are generally required by the private equity investor. Good leaver clauses are used when managers leave the company pursuant to a negotiated period of time. These clauses may also be triggered in case of death, continued mental or physical incapacity that prevents the managers from their duties, or simply their dismissal or removal for any other reason than misconduct. With regard to bad leaver clauses, these can be triggered in cases where the manager has left earlier than the planned negotiated term or has been dismissed or removed due to 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?

Most of the time, private equity portfolio companies adopt the form of an SAS in France, which offers a high degree of operational flexibility and whose governance arrangement is freely determined by the articles of association. Generally, a board (often referred to as a "*comité stratégique*") is set up and the investor(s) have one or more mandatory members of the board. The parties freely determine the power of the board. When provided for in the articles of association, the operating conditions of the board are published at the commercial registry and accessible to the public. In the case where this board has similar powers as within a board of directors or a supervisory board in a "*société anonyme*", the identity of its members is published on the Kbis. It is also possible to provide for the existence of such a board in the shareholders' agreement but not in the articles of association. In such case, it remains confidential. Usually, the existence of the board is provided for in the articles of association, but the actual governance rules, the distribution of seats, reinforced majorities or even veto rights, are specified in a shareholders' agreement, which remains confidential.

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?

Investment funds have at the very least a stronger right to receive information on management decisions. They often also obtain an obligation for managers to submit specific decisions to the board for prior approval, such as investment, hiring and more generally expenditure exceeding a certain threshold in euros. They may negotiate a veto right on important or structuring decisions, such as the acquisition or sale of assets, the launch of a new activity or the sale of an activity or a restructuring operation. These rights are usually negotiated and provided for in 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?

In an SAS, any limitations of powers mentioned and provided for in either the articles of association (published at the commercial registry) or in an agreement (not published) are unenforceable against third parties.

For instance, a transaction carried out by the company with a third party in violation of a veto right (e.g. sale of an asset by the company without the investor's consent) cannot in principle be cancelled, even if the third party was aware of this violation. However, this transaction may be cancelled on the grounds that this violation exceeded the statutory provisions of the company.

Where a shareholder is in breach of its voting agreement described in the shareholders' agreement, they may incur a financial penalty. The said shareholders' agreement may also include other hindering sanctions, such as a bad leaver or an obligation to buy back the investor's shares. In the case of a corporate officer breach any of its duties, this may lead to a dismissal from the corporate office. In the case where a director is also shareholder, the shareholders' agreement may provide for additional sanctions such as bad leaver clauses.

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?

Shareholders must always act in compliance with the company's corporate interests. Under French law, a decision taken by a majority shareholder or a minority shareholder in its own interest that is contrary to the company's interest ("*abus de majorité*" or "*abus de minorité*") may be cancelled. However, this protection requires legal action, which can take time. It may be useful to anticipate potential conflicts of interest in a shareholders' agreement.

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 can be freely negotiated between the parties subject to public order dispositions and the company's articles of association. Special care should be given not to have any conflicting dispositions between the shareholders' agreement and the articles of association. As mentioned previously, the shareholders' agreement is only enforceable between the parties who have signed the said agreement and cannot be enforceable towards third parties.

Although the agreement may be governed by foreign (other than French) law, it may not contain any clauses that violate French public order disposition. We also suggest that in case the shareholders' agreement is governed by a foreign law, the said agreement is drafted in compliance with international private and public laws. Special care should also be taken when drafting in foreign languages and the relevant true legal meanings in French.

Subject to the above, shareholders' agreements in France may also contain voting commitments by the shareholder, the validity of which requires that the said commitment respects the conditions of application set forth by the case law and be limited in time. Case law has set forth the following non-exhaustive list of conditions: compliance with the company's interest and public policy; and absence of total deprivation or transfer of voting rights, etc.

Furthermore, a shareholders' agreement may also contain contain non-competition and non-solicitation undertakings, provided that they are limited to the protection of the company's interest, as well as limited both geographically and in their duration. Another consideration to be taken into account for the drafting of the non-compete or non-solicitation clauses pertains to the actual status of the person towards which such clauses should apply, whether or not the same person is also an employee, a board member, etc.

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?

Each board member is liable to the company and to third parties for acts performed in the course of its duties. In the case of proven damage where the wrongful act has been committed by the board, its members are jointly and severally liable unless a member can prove that the decision was taken in his absence and that his absence was justified by a legitimate reason. The board member is also likely to incur criminal liability under the same conditions.

Directors must act in the company's best interests. Directors nominated by private equity funds must be careful to manage any conflicts of interest, particularly between the interests of the target and those of the fund they represent.

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?

Board members are bound by a duty of loyalty to the company. French law has set up a procedure to manage conflicts of interest ("*procédure des conventions réglementées*") that prohibit an executive or any shareholder holding a certain percentage of capital not to vote at the general meeting on agreements in which he is interested. In addition to these legal rules, a board's internal rules may be usefully adopted to prevent conflicts of interest among its members.

4 Transaction Terms: General

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

Prior to the start of any transaction, one should consider the actual duration of the due diligence and financing issues pertaining to the transaction. Under French law, the transaction may also fall within the scope of the merger control procedure at both French and European level, thus extending the timetable for the completion of the transaction. Under certain conditions, the transaction may also require prior information to the work council of the company and, at last, the existence of the Loi Hamon may also extend the timeframe of certain transactions. Finally, certain operations may also fall under the control of the Minister of Economy and Finance (*Investissements étrangers en France*).

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

Currently, there is a record of number of deals in private equity following the first COVID-19 lockdown. Most private equity investors are eager to finalise the transactions before the forthcoming presidential elections in France. This is a direct consequence of the tax and labour law reforms, which have been implemented during the past four years. The market is flourishing and France will probably live up to its ambition of becoming a major player on the European 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?

Public-to-private transactions were quite limited up until the entry into force of the Loi PACTE, which lowered the threshold to 90% of the share capital and voting rights in a takeover for publicly listed companies, thus aligning France with its European neighbours. The acquisition process is also more complex since these transactions involve public listed companies.

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

The regulation in relation to public acquisitions is set forth under various laws and regulations: the French General Tax Code; the General Regulations of the AMF; the French Commercial Code; and the French Monetary and Financial Code. These refer to certain principles of equal treatment, market transparency, fairness, 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?

Traditionally, from a buy-side perspective, private equity investors will favour a consideration structure based on a completion accounts mechanism, as it offers more security and precision and corresponds to the "right price".

However, this structure is more costly and time-consuming to implement, incurs greater work to be carried out upon and post completion and has a higher risk of dispute.

Therefore, more and more deals are based on a locked-box structure, with a set consideration based on locked-box reference accounts and a set of authorised and non-permitted leakages.

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

For obvious reasons relating to the nature of the sellers, private equity funds refuse to grant warranties/indemnities to buyers, or will merely grant such warranties/indemnities in a very reduced scope and duration, e.g. specific warranties and indemnities.

Due to the importance of the management team in a private equity deal, the warranties and indemnities will also be reduced to a minimum. In the event the founder and management team bear some/extra warranties/indemnities due to the fact that the private equity seller does not grant any, the sellers may try to negotiate a differentiated consideration in favour of the management.

In recent years, the French market has been living a fundamental modification of the warranties/indemnities package, as parties have worked on alternative solutions, such as subscribing warranties and indemnities ("W&I") insurance policies. This change of approach transfers the burden of the warranties and indemnities to an insurance company and eases negotiations and post-closing relations between 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?

Under French law, the most important terms of a deal relate to (i) the scope of the acquisition, and (ii) the consideration as they are a condition of validity of the agreement. However, share purchase agreements contain many other pre-completion and post-completion covenants and undertakings, such as:

- adjustments of the scope or prior operations including divestments, acquisitions, mergers, change of legal form, etc. – such covenants shall cover the treatment of any consequence triggered by the adjustment (tax, labour, financial, etc.);

- the management of the target company during the interim period and restrictive covenants on certain decisions, costs and expenses;
- warranties and indemnities, including *de minimis*, thresholds, cap, and "guarantee of the warranties" mechanisms/ any specific warranty mechanism;
- non-compete and non-solicitation undertakings; and
- closing deliveries.

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 our opinion, the French legal market is often several years late compared to other European countries. Recourse to representation and warranty (more frequently referred to as "W&I") insurance is increasing considerably, even though it remains relatively minor in the deals we have dealt with. We are confident that W&I will grow rapidly in the next few years, as costs feel largely acceptable when compared to the advantages that such a solution procures, e.g.: easier negotiation of broader warranties and indemnities; ability to organise "clean exit" structures for the seller; better long-term relations with the management team; and cost- and time-saving in relation to post-completion W&I implementation. Furthermore, the W&I insurance solution does not render the deal process and timing excessively more complicated.

From our experience, the cost of a W&I insurance premium ranges roughly between 0.8% and 1.3% of the insured value. Typical excesses in an operational French transaction would be around 0.5% of the target's enterprise value (and no excess would be applied in an infrastructure deal). Limits depend very much on the target's business and how risk-averse buyers are, but a typical range would be 10% to 30% of the target's enterprise value. The insurance policy is mainly subscribed by the buyer who may bear the full cost or negotiate to share costs with the seller(s).

Nevertheless, such a solution is not 100% sufficient to deal with all exposures as insurance policies will not cover certain identified or specific risks depending on their nature, e.g. disclosed risks, uninsurable criminal sanctions, pollution issues, 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?

As mentioned previously, private equity sellers seek to exclude any sort of warranties and liabilities and, in some cases, accept to apply a price discount in favour of other sellers (e.g. management) to avoid such warranties. In the event the private equity seller is compelled to grant warranties and indemnities, it will negotiate its limitation on as many aspects as possible: scope; duration; *de minimis*; threshold; and cap, for instance

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 resist any sort of security for any warranties/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 buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Usually, by the time that the put has to be made, it is common for the potential buyer to provide proof of the debt financing through a mandate letter signed by the bank (or the banking pool if the deal is a club deal or is structured), to which an agreed form of the debt financing term sheet (or head of terms) is appended.

It is also common practice for the term sheet to include a "certain fund" clause, according to which the lenders undertake to provide the financing without any reservation for a fixed period (i.e. three or six months); such provision is subject to a specific commission to be paid by the borrower.

As for the equity financing, in the event that an investor is anticipated to provide all or part of the equity, the put option usually needs to be appended with a signed offer letter ("*lettre d'offre ferme*") from the investor (or investors), as well as an agreed form of a shareholders' agreement term sheet.

Finally, with respect of the enforcement right of the sellers, depending on the scope of the deal – for example, from low to middle cap deals – it is not unusual not to have any specific guarantee provided and to simply refer to more traditional contractual rules that apply.

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

Even though such clauses prove to be very interesting, we have not (or very scarcely) encountered them in private equity deals. We would say that they are not common practice in the French 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 market risk is probably an important challenge, together with the time and cost of an IPO exit. Private equity investors should also be careful when lock-up agreements are included within the shareholders' agreement.

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

These duration of the lock-ups may vary between 90 days to a 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?

Although the dual-track exit process is rare in France, some sources also confirm that, generally in Europe, the dual-track exit or even triple-track exit process will decrease slightly.

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 main source of financing is the subscription of a loan from a credit institution or a banking pool. Companies can also obtain financing though bonds (straight or convertible bonds into shares), in addition to bank loans, or resort to bond financing, often in addition to the bank loan.

The high-yield bond market is overheating, and some predict a compression of credit spreads.

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 French law, a company is not allowed to finance the purchase or the subscription of its own shares or to use its assets to secure the purchase or subscription of its own share.

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

A recent study shows that the debt financing market in France remains strong amidst the COVID-19 crisis. For instance, the number of medical and biotech companies receiving private debt financing has almost tripled. Although recently there was a trend in "unitranche" loans, these types of financing have decreased. Another interesting point is that private debt funds are now also taking over from banks, which are taking a step back. A recent study also shows that the French debt funds raised €2.3 billion to finance infrastructure projects.

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 investors can benefit from an attractive tax consolidation regime. French corporations and their 95%-owned subsidiaries may elect to form a tax consolidated group in order to combine their profits and losses. The corporate income tax is then paid on the aggregate result. French subsidiaries of a same EU parent company may also elect to form a tax consolidation between themselves. In private equity investments, this regime allows for the charge of interest on the acquisition-related debt on the target's profit.

The tax rules allowing the deductibility of interest expenses have changed a lot over the past years. Based on the EU Directive ATAD, the amount of financial expenses allowed for tax deductibility is capped to certain limits, which would vary depending on the company's EBIDTA, its thin-capitalisation status, the group structure, etc.

Transfer pricing rules would also apply to shareholders' loans, for which the taxpayer must justify that the interest rate is arm's length.

Anti-abuse and anti-hybrid mechanisms have also been introduced recently.

As such, the use of off-shore structures is 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)?

In France, incomes from capital (interests, dividends, capital gains on shares) are, in principle, taxed at a 30% flat tax, whereas salaries are taxed at the progressive rates of personal income tax (with a maximum rate of 45%) plus social security charges. It is thus more tax-efficient to use the flat tax regimes on capital gains. However, the tax administration often tries to re-qualify the gain realised by the manager as salary and not capital gain. The French fiscal administration is very strict on the use of such mechanisms. A couple of years ago, France's administrative courts stated that the capital gains in a management package granted to the manager, provided that they are in relation to the risk allocated in the beneficiary's quality of investor, and not as a result of his performances, would not be re-qualified as salary. In three recent decisions (July 2021), the *Conseil d'Etat* (highest administrative court) ruled that the gain realised by the manager may be taxed as a salary if the gain is linked in one way or another to the employment contract and if he has benefitted from it into consideration for the role he exercises in the 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?

Within the tax-consolidation regime, the "*Charasse Amendment*" provides for a partial recapture of financial expenses borne by a French tax group 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, if the sellers remain majority shareholders, the "*Charasse Amendment*" may lead to the exclusion of the acquired entity from tax consolidation.

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?

France has introduced supporting measures to help French companies facing the pandemic crisis. No major reform is expected before the presidential elections in 2022.

The Finance Act for 2018 provided for a decrease of the corporate tax rate. Initially set at 33.33%, it gradually decreases to reach 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?

The general legal and regulatory framework described throughout this chapter illustrates the French market's ambition to become a central player in private equity.

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

As previously mentioned, certain transactions may fall within the scope of the merger control procedure set forth by French and European laws. Some other transactions may also fall under the control of the Minister of Economy and Finance (*Investissements étrangers en France*). Finally, certain sectors are also regulated, e.g.: finance and insurance; audio-visual; and the manufacturing of military equipment. Special care should be taken in order to take these aspects into consideration very early in the transaction, so to minimise their impact on the timetable of a transaction.

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.)?

Generally speaking, any serious due-diligence process conducted by private equity investors is carried out with a lot of care, thus rendering the process fairly long depending on the size, complexity, maturity and area of activity of the target. The due diligence may be pushed further depending on the nature of the private equity's funders.

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.)?

Naturally and like most other foreign countries, France regularly upgrades its level of anti-bribery and anti-corruption legislation. As a consequence, private equity investors necessarily increase their prior investment requirements and investigations in relation to the contemplated target. This causes extra delays, due diligence and contractual protection.

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 principle, no private investor should be worried about being held liable from any underlying portfolio companies' liabilities, as long as:

- the said company is limited liability company, which is mainly the case;
- the private equity investor does not grant to any third party any security or warranty to secure the liabilities of the underlying portfolio companies;
- any underlying portfolio company's economic difficulties are not triggered by the private equity investor's financial policy;
- the private equity investor does not push its control over its underlying portfolio too far and may be considered a consequence as a manager; and
- any contractual or financial relations with the underlying portfolio remain arm's-length-based relations.

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?

Under French President Emmanuel Macron, a series of rules has been simplified in order to favour foreign investments in France. Among these recent modifications, are the simplification of French labour law and the progressive reduction of corporate income tax. Brexit-related issues should still be anticipated and should mainly be in favour of French attractiveness for foreign investments. Finally, as mentioned above, general CSR, as well as sustainable development concerns, will continue to strive in the French private equity market, namely and as mentioned at the beginning of this chapter, with the success of impact funds.

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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?

Germany is a highly attractive market for M&A and private equity in particular. Both private transactions by way of purchasing the share capital or assets of a target, as well as public takeovers of listed companies are common types of transactions in Germany. Transactions further include minority investments (including in listed companies, so-called PIPEs), joint ventures and distressed transactions.

After a slowdown of deal activity in Q2 2020 due to the COVID-19 pandemic, transaction size and quantity in the German private equity market has since increased and remains on an upward trend. Sectors currently experiencing the strongest activity include healthcare, technology and industrial. Germany has become a hotspot for deal volume and activity, making it one of the premier places for private equity investments in Europe.

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

Germany is known for its *Mittelstand*, a large number of medium-sized, mostly family-owned (and often family-led) enterprises that have proven to be resilient players in crises and provide for a strong growth potential. With a substantial number of those *Mittelstand* companies going through generational changes, new investment opportunities arise. At the same time, Germany has produced a number of successful hidden champions and is increasingly seeing venture capital funds investing in start-ups, building up new companies with an international reach and customer base.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

The German government has provided a number of different COVID-19 relief measures, including government-funded short-time work, VAT deferment, short-term aid in case of revenue loss and loans to businesses backed by a government-owned promotional bank. Further, the obligation to file for insolvency has been suspended under certain circumstances, allowing bruised companies to restructure outside of insolvency proceedings. With the help of (often government-backed) loans, many companies refinanced over the course of the last year.

While the signs point to an exceptional year of deal activity for 2021, it is at this point difficult to foresee the long-term effects of the COVID-19 pandemic for the private equity market in Germany, particularly once the suspension of the obligation to file for insolvency expires. However, market sentiment in Germany is currently improving and most market participants expect an increase in both deal activity and deal volume in the years to come.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

No. We rarely see non-traditional private equity funds, such as sovereign wealth funds, pension funds or family offices taking active positions. They do, however, play a role as non-active co-investors.

2 Structuring Matters

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

When it comes to German private deals, acquisition structures usually involve one or more foreign entities, which in turn hold one or more German limited liability companies (GmbH). Management equity programmes are structured by way of German limited partnerships, having a German limited liability company as their sole general partner (GmbH & Co. KG).

Debt is usually taken up at the level of the foreign companies. Co-investors, if any, are usually also invested at the level of the foreign companies.

2.2 What are the main drivers for these acquisition structures?

The acquisition structure is largely driven by tax considerations, financing requirements, as well as the individual preferences and requirements of the management (in particular where sellers roll into the new structure).

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

In a plain vanilla acquisition structure, the German entities will issue ordinary shares, i.e. ordinary equity. In addition, one or more of the (foreign) upper-tier entities may grant shareholder loans to the German BidCo and/or the target companies. At the foreign entity level, hybrid instruments, preferred shares and shareholder instruments may play a larger role, in particular if co-investors are involved.

The management equity vehicles will have sweet and institutional strip equity in which certain of the members of management may participate.

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

The structuring drivers set out above also apply when the private equity investor is taking a minority position. The investor's ability to enforce the desired structure will largely depend on its negotiation power in the deal. The same applies to the investor's ability to obtain minority protection (i.e. through veto rights, etc.).

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 amount of management equity very much depends on the specific deal size and structure and therefore varies from transaction to transaction. As a general rule of thumb, the larger the transaction, the smaller the management's stake in the ordinary equity will be.

Customarily, the investor will have drag-along rights and grant tag-along rights to the managers. The investor will further retain the right to acquire the manager's equity stake following the termination of his/her employment with the target group, while the terms for such acquisition will depend on whether the manager is a good leaver or a bad leaver.

The management shares usually vest over a term of four to six years, either on a constant basis (which is most common) or on a cliff-edge basis on completion of the entire vesting period or certain milestones.

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

The investor will seek to conclusively define the criteria for good or bad leavers. Consequently, any leaver who is not a good leaver (or bad leaver, as the case may be) according to these criteria will be a bad leaver (or good leaver, as the case may be). Good leavers cases usually comprise (i) the death or permanent disability of the manager, (ii) reaching a certain retirement age, (iii) mutual termination, (iv) termination of the employment relationship by the company (or failure to prolong or renew such relationship) unless the manager has set an important cause, or (v) termination of the employment relationship by the manager (or failure to prolong or renew such relationship) if the company has set an important cause. The leaver definition may vary on a case-by-case basis.

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 usually purchase shelf companies (or set up new companies) in the legal form of a limited liability company (GmbH). Other entities in the acquisition structure may also involve entities under foreign law (see also question 2.1).

A German limited liability company is governed by one or more managing directors. Depending on the shareholders' decision, they may represent the company alone or together with another managing director or authorised officer (*Prokurist*). The shareholders will usually set out details of the managers' duties in rules of procedure for the management, which usually include a catalogue of reserved matters for which shareholder approval is required. In co-investment cases, such shareholder approval right is usually transferred to a board at the level of one of the upper-tier entities.

The only constitutional documents required for the limited liability company are its articles of association, which must be registered with the commercial register and can be obtained by any interested party from the commercial register, making them publicly available. In co-investment or minority cases, investors will often set out details regarding the relationship of the investors in a shareholders' agreement governing minority rights, change of control, drag-along, tag-along rights, pre-emptive rights, rights of first refusal, rights of first offer, as well as rights regarding IPOs and conflict resolution mechanisms. The shareholders' agreement may require notarisation (depending on the subjects it covers) but can remain private and does not have to be filed with a register.

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?

German limited liability companies are run by managing directors that are appointed by the shareholders. Generally, the investor appoints (and dismisses) the managing director(s) and may instruct them to take (or refrain from taking) certain actions. In addition, the investor will usually implement a catalogue of reserved matters, i.e. set out matters in detail for which the managing directors require prior approval by the shareholders (or a designated corporate body, such as an advisory board). The managing directors are further bound by a duty of loyalty *vis-à-vis* the company.

In a situation where the investor holds a minority position, the investor will seek to obtain veto rights in order to economically protect its rights through, *inter alia*, anti-dilution provisions, tag-along and drag-along rights, restriction of share transfers, and change of control rights.

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 of the shareholders to actions by the management (or other limitations) under rules of procedure do not limit the managing directors' power of representation *vis-à-vis* third parties (save for some very narrow exceptions). However, very strict veto rights that would limit the managing directors' ability to govern the company on their own may have detrimental effects: for non-German shareholders or, as the case may be, advisory board members, veto rights that restrict the managing directors in their ability to run the company may, in extreme cases, create a tax presence of such shareholder or advisory board member in Germany and/or may lead to a shareholder or advisory board member assuming the role of a factual manager for insolvency purposes.

In addition, both shareholders and managing directors are bound by a duty of loyalty *vis-à-vis* the company. Majority shareholders further have a duty of loyalty *vis-à-vis* minority 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?

In general, shareholders are free to agree on rights and obligations in a shareholders' agreement or the articles of association of the company.

Under German statutory law, shareholders have a duty of care and loyalty both *vis-à-vis* the company as well as *vis-à-vis* each other. The characteristics of such duty depend on the legal form and the shareholder base (e.g. smaller *vs* larger shareholder base) but generally speaking, shareholders are prohibited from taking actions that intentionally harm the other 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)?

Shareholders' agreements relating to German target entities are usually subject to German law, but statutory law would allow those agreements to be governed by laws other than German law. However, sections of the agreement relating to rights and obligations with regard to shares (e.g. drag-along rights, pre-emptive rights) would have to be subject to German law.

Non-solicit and non-compete provisions are generally permissible but are subject to certain limitations, such as maximum terms as well as restrictions with regard to location and 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?

German statutory law does not provide for material limitations regarding the appointment of managing directors; only certain minimum criteria must be met (e.g. the person must be of legal age and may not have been convicted of certain financial crimes). Depending on the legal form of the company, further restrictions may apply (e.g. maximum number of supervisory board members under German stock corporation law).

Prior to installing their own employees as managing directors of target companies, private equity investors should consider whether the appointment may have a regulatory impact on the target company or may jeopardise the status of the fund entities. Further, if non-German domiciled managing directors are to be appointed, potential tax consequences (such as the target company establishing a presence outside of Germany) should be considered.

Managing directors and board members of a company (including those nominated and appointed by a private equity investor) have a duty of care and loyalty *vis-à-vis* the company and must, at all times, act in its best interest. In case of a violation of said fiduciary duties, the respective managing director is personally liable for all damages resulting therefrom. In recent years, German courts have taken a stronger stance against managers who violate their fiduciary duties. In practice, the number of actual claims against managing directors remains, however, very low and mostly limited to cases of fraud.

Members of an advisory board have similar fiduciary duties as managing directors. Their involvement in business decisions is, however, limited which further reduces their involvement in actions that may result in damages to the company.

Both board members as well as managing directors are usually covered by D&O insurance, which is common practice in Germany.

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. The duty of loyalty requires that managing directors act in the best interest of the company. As the interest of the private equity investor would usually align with the interest of the company and the target group, there is, in practice, little room for conflicts of interests between the managing directors and the private equity investors.

4 Transaction Terms: General

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

The timetable for a transaction is usually driven by the due diligence process, negotiation of the purchase agreement, obtaining debt and equity financing, the W&I process, and regulatory approvals.

Regulatory approvals that are required for a transaction commonly include antitrust clearance. Antitrust clearance may be required either under German law (in which case the German Federal Cartel Office is the competent authority) or under European law (in which case the European Commission is the competent authority). In most cases, the clearance process takes approximately one month (or 25 working days) and is conducted between signing and closing. Transactions for which a "Phase 2" process is required by the antitrust authority will take longer to clear.

Transactions by non-European investors in specific sectors that concern national security (such as defence, IT, medical or media) may require additional clearance by the German government. Recent reforms of the German Foreign Direct Investment Act have expanded the scope of transactions covered by the act. A standard clearance process will take between four to eight weeks and may be conducted between signing and closing.

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

Over the past few years, competitive auction processes have become the standard for exits of private equity transactions. Due to the large demand for transactions and the availability of both cheap debt and equity, transaction terms have shifted to be seller-friendly (i.e. shorter liability periods, a decrease in the scope of representations and warranties). In addition, deal protection and transaction time have become more important, making pre-emptive bids widespread in German auction processes. W&I insurance has become the norm in private equity 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?

The German Takeover Code provides for strict rules (including minimum price rules) and requires a detailed legal and commercial analysis from a very early stage of the transaction. Public-to-private transactions provide for certain particularities, including the lack of (or reduced) availability of information for due diligence, detailed rules and timelines for tender processes, and the offering of a consideration (minimum price and limitations as regards the offering of non-cash considerations apply), as well as the support by management and supervisory board. Prior to making the tender offer, the investor should map out potential next steps, including entering into a domination and profit and loss transfer agreement with the target company as well as a squeeze-out of minority shareholders.

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

Deal protection in public-to-private transactions include entering into a business combination agreement with the target company providing for a "no-shop" clause and other support obligations. While the management of the target company must consider competing bids, it can agree to a no-shop clause, restricting the target from actively soliciting competing offers.

Further, bidders may enter into irrevocable undertakings with key shareholders. Under those agreements, the shareholders commit to tendering their shares in the tender process (assuming certain minimum conditions, including a minimum price, are met), even if another bidder makes 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?

Private transactions provide for both locked-box as well as completion accounts structures. Locked-box structures may be advantageous, especially for private equity investors (both on the sell-side and the buy-side), as they provide for purchase price certainty, allowing investors to calculate the needed funds for the purchase price paid (buy-side) and permit the immediate distribution of funds (sell-side), as no post-closing adjustment will be required.

Deferred purchase prices, in particular through earn-outs or vendor loans, are prevalent. In primary transactions (i.e. purchase from a non-private equity seller), re-investments (roll-overs) by the seller into the private equity investor's purchaser structure are common.

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

As they are seeking a quick and clean exit, private equity sellers will typically only give fundamental warranties (i.e. title to shares, authority) and certain other limited warranties relating to the business of the company (such as IP, IT, labour and employment, tax). In the current competitive market environment, private equity sellers offer even fewer business warranties. The availability of W&I insurance can bridge that gap by providing protection to the buyer while limiting the seller's exposure to potential claims.

In addition, the seller may provide certain indemnities with regard to special items identified by the buyer during diligence.

Selling managers will usually participate in the same package as negotiated by the buyer, while limiting their overall liability to their portion of the purchase price.

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 includes no leakage covenants (relevant for locked-box transactions), and covenants regarding the conduct of business until closing, the provision of information and assistance with regard to permits and regulatory clearances.

Selling managers often grant non-compete covenants and other 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 has become standard in private equity transactions to bridge the gap between sellers' and buyers' interests in a clean closing (see also question 6.2). Policy terms largely depend on the insurer, target industry, quality of diligence, and availability of management, the term and deductible, and the liability cap. Typically, excess amounts are between 0.25% and 0.5% of the enterprise value; excess under the W&I policy can be set irrespective of the management/warrantor liability under the SPA which is typically set at EUR 1. The cost of the insurance is approximately 1% to 1.3% of the amount insured.

Policies will provide for certain exclusions due to either general insurability or known risks and gaps in diligence. In the current market, sellers will not stand behind warranty claims that are excluded from the insurance.

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

Warranties usually survive a limited time after closing and are capped and further limited by *de minimis* and thresholds or baskets. The survival period for fundamental warranties usually runs longer compared with other warranties and is kept at the purchase price; even longer periods commonly apply to tax indemnities.

Liability for no-leakage covenants is usually uncapped and fully recoverable within a limited time after 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)?

Given the limited amount of warranties being provided by private equity sellers and the wide availability of W&I insurance, escrows have become unusual for private equity 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 buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Private equity investors will provide equity commitment letters and debt commitment letters. The equity commitment letter is either directly addressed to the BidCo and seller, or the seller is named as third-party beneficiary under the letter. Under the equity commitment letter, the fund undertakes to provide the BidCo with the equity required for the payment of the purchase price (subject to the fulfilment of the closing conditions under the purchase agreement) or damage claims resulting from a breach of the purchase agreement.

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

Walk-away rights of the buyer are rarely seen in the current German 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?

In an IPO scenario, private equity investors will usually be bound by lock-up provisions (see question 7.2), providing for a minimum holding period of the private equity investors. After expiration of the lock-up period, the private equity investor may only be allowed to sell stock to the market in staggered transactions so not to negatively affect the stock price.

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

Lock-up provisions in an IPO context are standard. Usual terms range from approximately six months for private equity investors, to 12 months or longer for managers, resulting in a delayed exit for the private equity investor.

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?

Particularly in large exits, private equity sellers are considering dual-track exit processes. The IPO process usually serves to increase competitiveness in auction processes and provide transaction certainty for the seller. Whether the IPO or the private sale will prevail will ultimately depend on the individual case; 2021 has already seen a number of successful IPO exits by private equity investors (and the management).

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 source of debt finance used to fund private equity transactions remains debt financing by financial institutions. Financing for larger transactions typically include term loan Bs (TLB), a tranche of senior secured credit facilities that is non-amortising and provided by a mix of financial institutions and institutional investors.

In addition to traditional senior secured debt, (high-yield) bond financing remains an important source of funds for large private equity transactions. Bonds are frequently issued through Luxembourg- or Dutch-based vehicles and are often New York law-governed.

Other financing options are alternative debt providers, such as unitranche financings by direct lending funds or institutional investors or Mezzanine capital providers that provide unsecured subordinated financing. Lastly, payment in kind loans (PIKs) that allow for interest to be capitalised (rather than paid in cash) have become popular in the recent past.

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 public takeovers, German law provides for a certain funds cash confirmation by a bank. Subject to the equity funding by the private equity investor, the bank will (subject to only very limited conditions) confirm that the private equity investor has available all funds required for the transaction. As a consequence, the financing of the transaction must be fully committed prior to launching the offer. German law provides for certain restrictions relating to financial assistance and upstream loans, as well as upstream and cross-stream guarantees and security. To comply with such upstream limitations, guarantees and security by German entities typically contain contractual limitations on enforcement, which materially impair the value of such guarantees and security.

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

While COVID-19 initially led to less availability of debt financing in Q2 2020, thanks to low interest rates, debt is widely available and debt providers seek to provide financing to all sorts of transactions, including small ones.

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 main focus of the private equity investor's tax considerations is finding a tax-efficient structure with respect to (i) the acquisition, (ii) the ongoing taxation, and (iii) the later sale of the target (exit). Structuring of the transaction, i.e. both the type of deal (share deal *vs* asset deal) as well as the set-up of the acquisition structure will largely depend on the details of the individual case (e.g. if the transaction involves multiple jurisdictions, complex (tax) group structures or if the target has significant loss carry-forwards), so that the respective tax structure and implications must be thoroughly assessed on a case-by-case basis. Especially with regard to highly leveraged acquisitions, it should be taken into account that many European jurisdictions (including Germany) provide for interest barrier rules, restricting the tax deductibility of net interest expenses.

Further, private equity investors will often want to ensure that their non-German entities and non-German domiciled individuals will not become subject to tax in Germany.

Off-shore structures play a role for the general structure of private equity investors investing in Germany, but are usually situated multiple layers above the German BidCo. Typically, the holding structure above the German acquisition and holding entities involves a number of Luxembourg entities.

In any case, the involvement of multiple jurisdictions in a transaction also increases the complexity for (German) tax purposes, given that further important (international) tax aspects (such as the residency of relevant entities or the application of double taxation treaties) must be considered.

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 will want to ensure to participate in a future exit via management incentive programmes (MIPs). Therefore, the management is regularly provided with actual or virtual shares, which may generate high returns under certain criteria (such as the fulfilment of certain key performance figures). Under German tax law, virtual share option programmes (VSOP) are more flexible in this regard and can be narrowly tailored to the parties' preferences in the individual case. However, VSOP income principally qualifies as employment income, which will be taxed at the individual tax rate of the German manager of up to 47.5% (plus church tax (*Kirchensteuer*), if applicable). In contrast, if certain guidelines are followed, proceeds from actual equity share programmes may qualify as capital gains, which would be subject to German flat tax at a beneficial rate of 26.4% (plus church tax (*Kirchensteuer*), if applicable).

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 management's main focus will be to ensure that tax will only be due upon receiving proceeds from a sale in order to avoid dry income. When following certain clearly defined steps, equity roll-overs can be structured in a tax-neutral way in order to avoid triggering realisation events.

Management will further want to make sure that any proceeds from an employment investment sale are treated as capital gains rather than income, as the latter would put a significantly larger tax burden on them (see 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?

The German Federal Fiscal Court has meanwhile issued a series of (recent) decisions dealing with the question of whether management equity programmes qualify for capital gains treatment and, in doing so, further clarified the requirements that must be met to achieve capital gains treatment.

Further, the German tax code has been recently amended (1 July 2021) to make stock option programmes for small and mid-sized companies more attractive by providing for tax-free amounts and avoiding dry income. The rules are specifically intended to apply to start-ups.

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 scope of the German Foreign Direct Investment Act has recently been broadened and is covering more industries and has lower thresholds (see also question 10.2). Further, certain temporary changes in the course of the COVID-19 pandemic (such as the suspension of the obligation to file for insolvency under certain circumstances was suspended) have had impacts on transactions.

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

Transactions by non-European investors (whether private equity or corporate investors) in specific sectors that concern national security (such as defence, IT, medical or media) may require additional clearance by the German government. Recent reforms of the German Foreign Direct Investment Act have expanded the scope of transactions covered by the act.

Funds, including private equity funds, managed by EU managers or marketed within the European Union are subject to certain rules of the Directive on Alternative Investment Fund Managers (AIFMD).

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.)?

Timing, materiality and scope very much depend on the target and the private equity investor. Given that W&I insurance is taken out in most private equity transactions, insurability of the diligence report has become a key factor for scope and materiality and should be closely aligned with the insurer.

Depending on the availability of information, due diligence takes approximately two to four 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.)?

Anti-bribery and anti-corruption have become standard diligence items. German anti-money laundering laws have put a special spotlight on various diligence items, but have otherwise not impacted the overall transaction and processes.

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?

Absent special contractual arrangements or fraud, it is highly unlikely that a private equity investor will be held liable for liabilities of a portfolio company; the same applies to 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?

Germany remains an attractive market for private equity transactions. The availability of small- and medium-sized companies that are often still family-led, looking for exit opportunities and offering high growth potential, as well as a growing number of start-ups and digital companies, provide for an attractive investment. The German private equity market is highly developed and allows for a swift execution of transactions.

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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?

The business environment for private equity (PE) transactions in Hungary have been favourable in recent years, though this has been struck down somewhat by the COVID-19 pandemic. Nevertheless, Central and Eastern Europe (CEE) is still 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 that 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. According to the market statistics of Invest Europe, in 2020, EUR 226 million was invested into Hungarian companies through 236 transactions. The total invested value represents a 15% increase compared to EUR 166 million in 2019, and the total number of transactions increased by 36%. According to the annual Investment Monitoring Report prepared by the Hungarian Private Equity and Venture Capital Association in collaboration with EY, as for the domestic and foreign transactions made by Hungarian investors in 2019, 245 investments were executed by Hungarian investors either in Hungary or abroad (16% higher than in 2019) for a total value of EUR 192 million, which represents a 7% growth *versus* 2019.

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

The strongest factor that is encouraging while also inhibiting PE transactions is the COVID-19 situation. On the one hand, the virus encourages investors to look for new investment possibilities and perhaps be less picky as to the expected standards and returns due to the struggling economy and the Hungarian Government is also re-allocating funds to aid companies in the most affected sectors (for example, tax and social contribution incentives have been introduced temporarily in the tourism and aviation sectors and new rules have been enacted to alleviate the operation of corporate entities). On the other hand, the restrictive measures, described in detail under question 1.4 below, enacted by the Hungarian Government create a new situation for everyone where both target companies and investors are still adapting to these new circumstances.

Without the virus outbreak, the balance would be quite positive for Hungary, which 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.

The availability of the European Union (EU) and domestic funds and their attractiveness to PE, the low interest rates and cheap financing possibilities, the booming start-up scene and 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.

Also, PE transactions are sometimes inhibited by the relatively small market itself. Dealmakers in Hungary are also keeping an eye on geopolitics and focusing on the occurring strains with the EU, a crucial trading partner and investor in the region.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

During the first wave of the pandemic, the Hungarian Government gradually introduced a series of emergency rules relating to various sectors of the economy. These rules scattered across various government decrees were later consolidated into a single act (Act LVIII of 2020 on transitional rules), which is currently in force in Hungary. The most important set of rules affecting PE investments in Hungary is the so-called foreign direct investments (FDI) screening regulation, which is a more ambitious and, in some respects, broader version of the 2018 FDI screening regime. The new regime's declared goal is to protect the public interest related to the security and operability of networks and equipment, and to the continuity of supply by restricting foreign investments made in relation to Hungarian "strategic companies". The Act provides that such transactions can only take effect if they are notified to and acknowledged by the Minister of Innovation and Technology beforehand.

For the purposes of the Act, foreign investors are private persons and legal entities domiciled outside the EU, European Economic Area (EEA), and Switzerland and other entities where a third-country shareholder holds majority. Strategic companies are all limited liability companies, private companies limited by shares or public companies limited by shares seated in Hungary if they are operating in sectors of strategic importance. The affected 23 sectors of strategic importance are established in a separate Decree (Gov. Decree 289/2020(VI.17.)) and include, among others, many sectors preferred by PE investors such as energy, transport, tourism, trade, construction, IT, telecommunications and healthcare.

Transactions falling within the scope of the Act are: (i) any transfer or acquisition of an ownership share in a strategic company; (ii) capital increase in a strategic company; (iii) the transformation, merger or division of a strategic company; (iv) issuing convertible bonds, bonds with subscription rights or converting bonds by a strategic company; and (v) establishing a right of usufruct over a share or business share of a strategic company provided that:

a) the foreign investor or an EU/EEA or Switzerland-based investor acquires a controlling majority;
b) the foreign investor acquires 10% ownership and the investment value exceeds HUF 350 million;
c) the foreign investor acquires 15%, 20% or 50% ownership; or
d) the foreign investor's ownership in the strategic company exceeds 25% as a result of the transaction.

The Minister shall provide reasons for a prohibiting decision and the foreign investor may challenge such prohibiting decision in a non-contentious administrative proceeding based on the alleged violation of the substantive rules of the procedure.

The acquiring party can apply for registration of its ownership in a strategic company only after acquiring the confirmation of the acknowledgment from the Minister. In the absence of a confirmation of the acknowledgment of the notification, or if the Minister passed a prohibiting decision, the acquiring party shall not be registered in the register of shareholders or members and may not exercise any rights in the strategic company related to the shareholding interest in question.

The Minister adopts its decision within 30 working days (or 45 if the deadline is extended) on the transaction by taking into account whether:

a) the notification meets the conditions set out in the Act;
b) a violation or compromise of state interest, public security or public policy of Hungary, or the possibility thereof, arises from the transaction;
c) the notifier is controlled, directly or indirectly, by an administrative organ of a non-EU State, also including state organs and armed forces, either due to its ownership structure or as a result of significant funding;
d) the notifier was already involved in an activity concerning security or public policy in an EU Member State; and
e) there is a serious risk that the notifier will perform an illegal activity or an activity constituting a criminal offence.

The failure to notify a transaction under the Act may result in a fine up to two times the value of the relevant transaction.

Further to the above, the recent change in the application of Act LVII of 2018 on Controlling Foreign Investments Violating Hungary's Security Interests, which will be detailed under question 11.1, should be noted.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

Other than the usual PE and VC investors, no other specific type of investor has emerged. The Hungarian Government pours state funds into the economy, but this is strictly an emergency type of aid and not an investment by any means.

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 for future investment rounds; however, in the 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 a 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 companies that issue business quotas 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 with 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 company.

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 a legitimate operation.

On the ownership level, the investor, especially if in 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 it is thus a rare sight. Notwithstanding the foregoing, in some cases, investors may decide to maintain the current management structure of the company but parallelly require the set-up of a shareholders' committee, the members of which are some of the shareholders of the company, including the member delegated by the investor that exercises veto rights on the highlighted issues. Although the members of the shareholders' committee are not qualified as executive officers (managers), it should be noted that since the shareholders' committee decides on matters that otherwise fall within the scope of the management level, under Hungarian law, in cases where the company goes into compulsory liquidation, the liability of the members of the shareholders' committee shall be considered as that of the managers if they have the actual power to influence the decision-making mechanisms of the company.

On the third level, investors may require the set-up of a supervisory board if they deem it necessary, which oversees 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 the case of a dispute, they can only be enforced in the 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 at 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. 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 the 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 levels, 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 such as 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 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 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 with 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, such as triggering exit rights at a given return on the investment, the 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; these undertakings are therefore 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 known as "executive officers") across all companies, regardless of nationality or 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 members: 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. However, in fact, investor-delegated members usually have less rights and information related 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?

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 at 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.

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, foreign direct investment 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 from one to three months.

Financing is cheap and easily available in Hungary for various PE transactions, but data protection issues, especially 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 a minor observation, but worth noting, that drag-along and tag-along provisions still form 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 has actually been 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 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 (such as 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 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 (i) a private equity seller, and (ii) the management team to a buyer?

The list of seller warranties and indemnifications is 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 uncommon, although they are 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 a 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 to the sellers who are still better off with the low premium rates.

W&I insurance also makes risky transactions more attractive and provides 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% and 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 and 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 guaranty, 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 buyer (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 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 (and 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?

Initial public offering (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.

It must also 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 an investor 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 IPO and a potential M&A exit, are not as common in Hungary as in other European countries or in the United States.

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 that 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 having 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. In addition, the anti-money laundering legislation has recently undergone a significant change in Hungary according to Act XLIII of 2021, pursuant to which, *inter alia*, the organisations that fall within the scope of the act are obliged to provide data on their beneficial owner(s), which shall be uploaded to the newly established register of beneficial owners kept by the National Tax and Customs Administration of Hungary.

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 15.5% social contribution (*szociális hozzájárulási adó*) applicable to natural persons realising any income based on the actual profit they make.

In the 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.

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. Since 2019, healthcare contribution has been 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% but later decreased to the current 15.5%. The current tax cap on contribution payment is currently HUF 622,728 for the year 2021.

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 due diligences 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 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 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 the 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 on Controlling Foreign Investments Violating Hungary's Security Interests, 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, according to the original provisions, any natural person or legal entity registered in a country outside of the EU, EEA or Switzerland is considered a foreign investor, but special account should be taken of the notable change as regards the application of the act, brought by Government Decree 532/2020 (XI. 28.) on the Economic Protection Measures to be applied during the State of Danger, pursuant to which the definition of foreign investors was extended to include the nationals of the States of the EU, the EEA and the Swiss Confederation and all legal entities or other organisations registered in such a State.

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 the 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 Hungarian Government regarding 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.

As a result of the change in the scope of the act as mentioned above, during the wave(s) of the COVID-19 pandemic, this act shall be applied in a more active manner in the course of acquisitions and capital investment transactions, in some cases parallel with the pre-notification set out in Act LVIII of 2020, as mentioned under question 1.3.

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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?

Growth and buyout transactions are common in India.

Despite several significant economic uncertainties brought on by the COVID-19 pandemic, the investment momentum in India, and in particular private equity (PE) deal activity, has picked up significantly. As per data released by the Indian government, foreign direct investment (FDI) into India grew by 19% during 2020–21, due to government measures in the form of policy reforms, investment facilitation and ease of doing business.

2020 witnessed multi-billion-dollar PE funds raised by Reliance Retail and Jio Platform, with a beeline of investors. Even aside from these headline transactions, there has been a steady PE inflow across sectors.

There is a lot of interest and dry powder allocated for investments in India, with continued heightened deal sourcing and preliminary evaluation activities. Some pandemic-resilient sectors like life sciences, pharmaceuticals and technology-enabled services continue to receive a lot of interest, whereas banking and financial services sectors have witnessed some uncertainty on account of COVID-19 and regulatory moratorium on certain loan repayments.

Consolidation by PE-fuelled platforms is also on the rise, with several large value acquisitions in the technology, healthcare and education sectors. PharmEasy's ongoing acquisition of Thyrocare (with a mandatory tender offer) is the first ever acquisition of a listed company by a PE-owned Indian unicorn. As funds and platforms focus on consolidation, this trend is expected to continue.

A buoyant stock market has fuelled the initial public offer (IPO) exit route for PE investors, with Zomato and Paytm leading the pack and several other start-up firms announcing their IPO plans.

Distress investment is also on the rise, with the new insolvency law settling in and COVID-19 generally impacting businesses.

Like other jurisdictions, there is an increased focus on environment, social and governance (ESG) criteria for investments, especially by sovereign wealth funds (SWFs).

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

A sustained interest in India and India-focused PE dry powder is a significant encouraging factor. In addition, local entrepreneurial ambitions and innovations have witnessed several start-ups transforming into unicorns, with unabated PE growth capital and remarkable returns on exit. The entrepreneurial machine continues to churn start-ups despite the pandemic.

The long-term impact of COVID-19 on the economy, consumer spending and businesses generally is still unknown, and concerns with respect to the financial sector and the non-performing assets continue to cast doubt on the sector.

On balance, PE transactions seem to be set on an encouraging trend, with the following factors working to their advantage:

(i) relaxations and time extensions for compliances, moratorium on insolvency proceedings, etc.;

(ii) legal and regulatory changes like relaxation in FDI limits for the insurance and defence sectors, proposal for a consolidated securities market code and tax incentives;

(iii) government reforms and initiatives such as 'Self-Reliant India'; and

(iv) India holding out as an alternative to China in the global supply chain.

Aside from the COVID-19 pandemic, some other key inhibiting factors are:

(i) restrictive legal and regulatory changes for foreign investment such as approval requirement for FDI from bordering countries (see question 10.1 for further details) and continued application of capital controls, which are being progressively liberalised but continue to exist; and

(ii) unreasonable valuation expectation exacerbated by multiple investors vying for the same asset.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

While COVID-19 has not impacted deal flow, a significant impact is the renewed focus on asset quality review and watertight documentation to provide for a pandemic-like situation. We also expect renewed focus on restructuring as India's FDI laws impose pricing guidelines that favour residents, and such pricing guidelines are applied on the basis of valuation of the Indian investee. We expect PE investors to focus on structures to ensure the return of capital despite a dip in valuation.

The government has intervened in the economy, and though such interventions are favourable as per our assessment, such measures have not influenced PE investors.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

Lately, SWFs impact investment funds and Indian family offices are executing PE style transactions.

Indian companies, at times, favour SWFs over PE investments, given the long investment horizon and the absence of a time-bound return of capital obligations. The holding period results in subtle differences in structuring of transactions involving SWFs.

India continues to impose capital controls and prohibition on assured returns for FDI and, given the longer holding period for SWFs and such restrictions not being applicable to Indian family offices, there is increased flexibility to structure such transactions.

Similarly, impact investment funds focus substantially more on specific ESG diligence, extensive representation, warranties and undertakings as a part of deal documentation and continued best ESG practices after investment.

2 Structuring Matters

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

PE transactions are typically structured as under:

(i) mode: through special purpose vehicles incorporated in 'in favour' tax jurisdictions, or trusts registered as alternative investment funds with the Securities and Exchange Board of India (SEBI), the country's securities regulator;

(ii) targets for investment: as FDI in companies, because FDI in other forms of entities, such as limited liability partnerships or trusts, is either strictly regulated or prohibited; and

(iii) investment instruments: by way of permitted capital instruments, which comprise of equity (can either be equity or preference shares, shares with differential voting rights, or partly paid shares) and/or equity-linked convertible instruments (warrants, compulsorily convertible preference shares or compulsorily convertible debentures).

2.2 What are the main drivers for these acquisition structures?

India continues to be a regulation-heavy jurisdiction, regulating entry as well as exit of foreign investors. Accordingly, structuring to ensure compliance with Indian regulations while achieving the investment objectives is the main driver. In addition, key structuring considerations are: (i) tax considerations; (ii) return expectations; (iii) investment horizon, i.e., the period within which the investor expects to exit and the preferred mode of exit (by way of secondary sale or IPO, etc.); and (iv) any specific demands or conditions from management team or sellers (in secondary transactions).

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

It is common for a private company to have several classes of equity or compulsorily convertible into equity securities. The classes of securities progressively decrease from private company, to a public unlisted company, and then a public listed company.

Equity for management personnel (except promoters) is through ordinary equity shares, employee stock options (ESOPs), warrants (performance/exit linked), or convertible instruments.

Carried interests are typically structured upstairs (i.e., to offshore entities) and sideways (i.e., to the investing SPV).

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

Minority transactions are structured to protect against the erosion of investment value and dilution of stake, and facilitate exits along with the majority stakeholders. Such protections are classically included as affirmative veto rights, anti-dilution rights, information and audit rights, audience to board meetings (as an observer) and transfer restrictions *vis-à-vis* other shareholders (by way of drag rights, right of first refusal, put options, etc.).

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?

Whilst not mandatory, the management is typically allocated equity as ESOPs (promoters are not permitted to have ESOPs) or warrants.

Vesting or conversion conditions are agreed on a case-to-case basis and usually linked to company's performance, investor exit or tenure of employment.

Indian law does not contain any compulsory acquisition provisions.

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

A good leaver is characteristically someone who leaves by providing prior notice, with reasonable cause (including on account of incapacity), and where termination is in compliance with the terms of his/her employment.

Contrarily, a bad leaver, leaves without notice and/or cause and is not otherwise 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?

Portfolio companies are governed by the terms of shareholders' agreement, which typically provide following governance arrangements:

(i) appointment of the agreed number of nominees on the board of directors (Board);

(ii) mandatory participation in quorum for meetings of the Board and shareholders;

(iii) affirmative veto rights on identified matters;

(iv) inspection and audit rights; and

(v) information rights.

These arrangements are not required to be publicly available but are usually included in the articles of association of companies for better enforceability. As articles of association are publicly available, in most cases, such arrangements are also made 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, typically PE investors and/or their director nominees are contractually entitled to veto rights at Board and shareholder meetings.

Minority investors typically negotiate limited veto rights on critical matters like changes to constitution or capital structure, matters regarding liquidation, alteration of constitutional documents affecting their rights, etc. Depending on the minority position, the list of the veto rights may be quite expansive.

In addition, investors also have a statutory veto on all matters requiring a special resolution of shareholders if they hold more than 25% of the equity capital.

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 such limitations. However, investor nominees have certain fiduciary duties as directors, including, to: (i) act in good faith to promote the company's objects; (ii) act in the best interest of the company, its employees and shareholders and community; (iii) not be involved in any situation with a direct or indirect conflict of interest; (iv) exercise due and reasonable care and independent judgment; and (v) not secure any undue gain or advantage.

These duties are available both under statute and common law and are not separately addressed as such.

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?

Indian law does not prescribe any specific duties for PE investors to other shareholders (including minority shareholders). However, qualifying minority shareholders have the right to approach a special court in case of oppression or mismanagement.

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)?

While Indian law does not contain any express limitation or restriction on contents or enforceability, parties typically opt for Indian law as the law governing substantial obligations in shareholder agreements, to facilitate enforcement of provisions in respect to, or *vis-à-vis*, the company. However, even where a shareholder agreement is governed by any foreign law, in a dispute scenario, the arbitration tribunal (as arbitration is the preferred mode for dispute resolution in PE transactions) is likely to consider mandatory legal provisions of Indian law in respect of provisions concerning the Indian company, failing which, the enforceability of the arbitral award in India may be affected.

Reasonable restrictions in the form of non-compete and non-solicit covenants on management and key employees are common and generally enforceable. However, non-compete provisions post-cessation of employment are contentious and may not be enforceable under Indian 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?

Indian law prescribes certain qualifications and conditions for directors of Indian companies, like requirement for a resident director, female director or independent director, limit on maximum number of directorships, etc. These are generally applicable and not specific to PE investor nominees.

Directors including PE nominees are liable for statutory breach, especially where they can be shown to have acted solely in the interest of their appointee. To manage liability, PE nominee directors are usually appointed in a non-executive capacity, as they are not employed by the company or involved in day-to-day affairs.

As for investors, there is no apparent risk or liability (other than reputational liability) as India maintains separate legal entity of a company and its shareholders until there is a reason for courts for lifting its corporate veil.

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 an actual or potential conflict of interest situation covered by Indian law, the law controls recusal and non-voting by interested directors. In other cases, a director may recuse on grounds of propriety, and require the shareholder to vote on such matters. Matters related to conflict on account of portfolio companies are handled through contracts, by approximately providing for matters such as corporate opportunity. Increasingly, Indian companies contractually require PE investors to not nominate a nominee director who is also a director at a competitor.

4 Transaction Terms: General

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

Below are some key issues that commonly impact the transaction timetable:

(i) where required, regulatory approvals or notifications in India (from or to the Competition Commission of India, the Reserve Bank of India (RBI) or the SEBI, for FDI in certain cases, or to any specific sectoral regulator or other governmental authority) are not time-bound and are often unpredictable;

(ii) any involvement of courts or tribunals in India may take inordinately long for approvals or sanctions; and

(iii) sometimes buyers include rectification measures for past regulatory lapses as pre-completion conditions in transactions, likely affecting the timetable, as these involve a governmental authority.

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

As PE in India continues to develop, transaction terms have gradually evolved and become standardised in various aspects. For instance, warranty coverage, indemnity caps and survival periods, scope of veto rights, etc. are well recognised.

Additionally, there is growing trend of investors having equal or, in certain cases, even greater management rights than the founders. This is a development from the early years when Indian businesses were primarily run by founders and financial investors had limited supervisory and information rights.

Lastly, there is an increased focus on thorough due diligence for every transaction, which often includes specific ESG and tax diligence.

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 or (take-private) transactions are difficult to achieve on account of: (a) the requirement that the majority of public shareholders must approve; and (b) the price must be discovered through a reverse book-building process that often results in high price discovery. Typically, such transactions are attempted only when the investor is willing to pay a high premium, and financing is arranged offshore. Take-private transactions, completed through a court-approved insolvency, are relatively easier and an exception, but this typically only suits special situation funds.

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

Indian law is premised on protection of interests of public shareholders and provides little protection to investors in public acquisitions. However, stringent insider trading norms and continual disclosure norms protect the investors as well.

Further, for deal-protection, PE investors are known to contractually bind the investee to covenants on exclusivity, break fees, etc.

Additionally, listed companies are mandated to make disclosure of material facts and events, which provides a certain degree of comfort to PE investors from a due-diligence perspective.

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 (paid through banking channels) is the most prevalent form of consideration, both on the sell-side and buy-side. This is primarily due to legal limitations surrounding the form and structuring of consideration involving foreign investors.

On the sell-side, investors may negotiate the amount of consideration payable, provided that the price complies with the FDI regulations on pricing guidelines. Non-cash consideration is permitted under Indian law; however, the income tax authorities have the authority to determine its fair value, which may be deemed higher than the agreed consideration and increase the seller's tax liability. Further, transactions involving non-cash consideration may also subject to specific conditions like valuation reports being obtained.

On the buy-side, investors may opt to defer payment of part of their consideration. Indian law permits foreign investors to defer up to 25% of the total consideration, through escrow mechanism or as an indemnity payment for a maximum period of 18 months.

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

(i) PE sellers generally provide limited representation and warranties (Warranties), in respect of their authority, capacity, solvency and ownership of shares (in a secondary transaction). Indemnities are, accordingly, limited to breach of these Warranties only. In addition, PE sellers may agree to a specific indemnity for identified items with negotiated terms on quantum, trigger thresholds, process, etc.

PE sellers are generally keen on hassle-free exits, and do not typically provide any business Warranties on grounds that they were financial investors and not in active management. This has contributed to the emerging trend (though not as common yet) for using RWI in transactions with PE sellers.

(ii) PE buyers on the other hand, customarily seek comprehensive Warranties (comprising of customary fundamental Warranties, business Warranties and tax Warranties), with recourse to general and specific indemnities from the management team upon breach. These include, the scope of Warranties, as well as limitations and exclusions for indemnities, which are often heavily negotiated.

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 typically agree to provide:

(i) standstill covenants on the maintenance of *status quo* (in terms of conduct and state of operations of the investee) during the period from signing to completion;

(ii) undertakings for agreed-upon actions for pre-completion (fulfilment of conditions precedent), completion and post-completion (if any); and

(iii) indemnities for breach of limited Warranties and 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?

RWI is rapidly gaining favour in transactions with PE sellers.

RWI policies are generally coterminous with the survival period for claims, which is usually three years for general Warranties and up to seven years for tax and fundamental Warranties. Liability limits are usually set out for the primary insurer, beyond which there is a tower of excess insurance with multiple insurers.

Standard exclusions are insurer-specific but generally include: issues known to the investor; estimates or projections; purchase price adjustments; consequential losses; uninsurable and criminal fines; stamp duty-related non-compliances; secondary tax liabilities; anti-bribery and corruption; and punitive damages, etc. Lately, COVID-19 is also being included. Further, the insurer may seek specific exclusions depending on the nature of the investee's business and specifics of the transaction.

Although the premium will depend on the transaction risk, as a general rule, it is in the range of 3–10% of policy limit. Additionally, parties have to bear a specified 'retention amount' before payment obligation under the policy starts, which is generally a specified percentage of the investee's 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?

The most common limitation is regarding the quantum of liability. Parties negotiate and set out the thresholds for *de minimis* (for an individual claim) and aggregate liability (for all relevant claims). The maximum period within which indemnity claims can be brought is also set out and varies for each kind of Warranty.

Parties also agree to standard principles of 'no double-recovery' and a duty to mitigate on the indemnified party.

Other acceptable exclusions are: contingent liabilities; tax liabilities (arising after completion); liabilities on account of change in law (after completion); voluntary acts or omissions by the indemnified; or loss otherwise compensated, etc.

Generally, only a restricted set of limitations apply to indemnities for breach of covenants and undertakings.

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)?

Typically, PE sellers or buyers do not provide any security (in form of escrow accounts) for Warranties/liabilities.

Lately, buyers are seeking RWI in acquisitions involving PE sellers as a substitute for escrow.

PE buyers, in some cases, may defer payment of a part of their consideration amount. This in turn acts as a security against breach of Warranties/liabilities by the 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 buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

There is no general statutory obligation on PE buyers in private acquisitions to provide any financing comfort, whether for debt or equity finance. The only requirement is in case an MTO is triggered in a public acquisition.

Sellers can contractually negotiate and agree on their enforcement rights. In most cases, buyers provide fundamental Warranties regarding sufficiency of funds, and provisions for funding obligation are simultaneous with the seller's obligation to transfer securities. Some sellers may insist on an equity commitment letter from PE buyers with third-party beneficiary rights. Common rights of enforcement available on breach include indemnity, specific relief and dispute resolution.

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

In India, there are no provisions for payment of reverse break fees under law but as an outcome of contract. Typically, negotiated terms include those in respect of quantum, trigger for payment, mode of payment, guarantees, etc. Due to the absence of an express legal regime, effecting payment of reverse break fees is expected to face several regulatory hurdles. For example, payment by a resident to non-resident may require prior RBI approval.

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?

(i) Only such equity shares or convertible securities may be offered for sale in an IPO, which have been held by the investor for at least one year as of the date of the filing of the draft red herring prospectus.

(ii) Other than the board nomination right, no special rights such as affirmative voting matters, are permitted to continue post-listing.

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

All pre-IPO shareholders are statutorily locked-in for a period of one year from the IPO and, hence, no separate lock-ups are entered into with PE sellers.

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?

In the last 12–18 months, considering the level of activity in Indian equity capital markets, most exits have taken the public market route. In certain cases, small market discovery or price benchmarking deals have also happened in the run-up to 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).

Funding through privately placed listed non-convertible debentures (NCDs) is a popular form of debt financing. Funds can be raised through foreign portfolio investors (FPIs) who can subscribe to NCDs issued by Indian companies as there is no cap on interest payout and can be accompanied with redemption premium, which in turn can provide equity upside.

Additionally, Indian assets can also be used to secure NCDs through an Indian debenture trustee, who holds security on behalf of NCD holders. The RBI prohibits Indian banks from granting loans for the purpose of acquisition of shares. While non-banking financial companies in India are permitted to lend funds for the purposes of acquisition financing, high borrowing costs prove to be a disincentive for PE investors.

Hence, any form of acquisition financing is often limited to offshore sources, which is also challenging owing to restrictions on the creation of security on Indian assets in favour of non-resident lenders. Investment structures using Indian companies owned or controlled by foreign investors are also not feasible, as law prohibits such companies from raising any debt from the Indian market for any further downstream investments.

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 limited end-use restrictions on unlisted NCDs that are privately placed; however, NCDs issued to FPIs for the purpose of acquisition require listing, and are liquid instruments. The RBI has introduced a voluntary retention route investment mechanism to enable FPIs to invest in Indian debt markets without any restrictions on minimum residual maturity, subject to a minimum retention period of three years, provided that FPIs retain at least 75% of invested capital in India for such period.

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

Owing to decreasing interest of investors in instruments like rupee-denominated (masala) bonds, India's union budget for FY 2020–2021 proposed a set of measures to boost debt financing. In order to facilitate enhanced participation from retail investors, long-term investors and pension funds, a new debt exchange-traded fund has also been proposed. Additionally, the SEBI continues to make amendments to protect investors of listed debt securities and enable debenture trustees to perform their duties more effectively.

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 should evaluate the tax treatment of capital gains, dividend income and interest income, and keep in mind the investment instrument employed and the jurisdiction through which the investment has been made. An offshore investor can choose between being governed by the domestic tax law or the relevant tax treaty, whichever is more beneficial. Offshore structures for investment in India are fairly common, particularly from jurisdictions with favourable tax treaties with India. However, with the recent re-negotiation of key tax treaties, the introduction of general anti-avoidance rules (GAAR) under Indian domestic tax law and India being able to implement the MLI provisions under the BEPS framework in certain treaties, access to tax treaty benefits has become dependent on various conditions, including the investing entity having adequate commercial substance.

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)?

Use of convertible instruments (at times with profit-linked conversion) is fairly common. Deferred consideration *per se* may not be workable because of regulatory constraints and complications in treatment of capital gains tax.

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?

In case of a direct transfer of investments held in Indian companies, tax implications could arise in India even where such transfers are part of an internal reorganisation. In case of multi-layer offshore holding structures, gains derived from an indirect transfer of Indian assets may be taxable in India. Thus, transfer of shares or interests in foreign entities that derive their value substantially from assets located in India would be subject to tax in India even without direct transfer of Indian assets. However, certain types of corporate reorganisations, such as offshore mergers and demergers, may be tax-neutral, subject to conditions.

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?

Typically, any changes in Indian taxation laws are brought about annually as part of the union budgetary exercise. Some key recent changes include the abolition of dividend distribution tax, introduction of equalisation levy in order to tax online service providers and tax deduction/collection obligations on sale of goods (including unlisted shares). Access to tax treaty benefits has lately become dependent on various conditions including the investing entity having adequate commercial substance.

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?

Lately, India has introduced mandatory government approval for foreign investment from countries having land borders with India, principally aimed at curbing Chinese investments and potential takeovers in light of the pandemic-induced slowdown. Effectively, it has expanded the list of countries whose investors are ineligible to invest in India under the automatic route. Subsequently, investments that would otherwise be permitted now fall under the approval route if the PE investor has a '*beneficial owner*' from any of India's bordering countries. Although there is some ambiguity around the interpretation of 'beneficial ownership', PE investors with even a single shareholder from the bordering countries could potentially qualify for the restriction.

The Indian Supreme Court has recently settled the long-standing controversy surrounding the choice of a foreign seat by Indian parties and enforceability of the award rendered therein.

Two Indian parties are now permitted to choose a foreign seat of arbitration and an award passed therein would be enforceable as a foreign award. This will enable PE investors investing through an Indian investing vehicle to choose a foreign seat of arbitration.

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

Recent trends in the Indian legal and regulatory landscape suggests that India is largely geared towards being an investor-friendly jurisdiction.

However, restriction on foreign investment from India's neighbouring countries has indisputably intensified regulatory scrutiny on PE investors (see the response to question 10.1).

In the last few years, another significant development has been a disclosure requirement of beneficial ownership for all companies. While this may not be specific to PE investors, it mandates all Indian companies to investigate their ultimate beneficial owners in certain cases, and make appropriate public disclosures.

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 thorough legal due diligence on investees but the scope, materiality and timeframe for diligence varies with each transaction, depending on the nature and complexity of the transaction and the transaction timetable.

Generally, the scope includes corporate matters, licences, contracts, indebtedness, labour, litigation, real and intellectual property, insurance, etc. The timeframe depends on the nature and scale of operations of the investee and can take a minimum of two to three weeks. Materiality thresholds for review are case-specific and are generally applied to contracts or litigation.

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.)?

Investors undertake specific due diligence for evaluating compliance with domestic anti-bribery, anti-corruption and anti-money laundering laws as well as internal standards. There is also a growing (and recommended) trend of engaging separate advisers for such diligence.

Investors also seek wide Warranties and undertakings from the company, founders, sellers (in a secondary transaction), and their immediate relatives, in respect of compliance with laws, their past and present conduct, relationship with government officials, etc.

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 the investor may not be liable *per se*, its nominee director may be held liable for actions of the investee in his/her capacity as director.

Under law, it is unseen for one portfolio company to be held liable for liabilities of another portfolio company. There is a remote possibility of this happening contractually. For instance, in the case of cross-guarantees.

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?

Recent deal statistics for growth and returns indicate India as an investor-favourite destination in the region, and this is reflected in consistent PE inflows. Nonetheless, investors remain worried about the constantly mutating legal and regulatory regime. Being a developing economy, Indian laws on exchange control, securities and corporate management are still evolving. Therefore, investors have to engage qualified local legal and financial advisers at the inception of every transaction, leading to unavoidable cost expenditure even for transactions that fall through.

The Indian judicial process, with its uncertain timelines, has been a concern; though investors invariably choose arbitration for dispute resolution, any court-driven approval remains a concern.

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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?

The Italian private equity market is well structured and encompasses a significant number of global, European and domestic private equity firms, carrying out most types of transactions, relevant processes and contractual documentation envisaged in the other sophisticated European and US private equity markets, as well as approximately 1,200 private equity-backed companies.

Private equity represents a fundamental part of the Italian economy, linking the globally recognised Italian family-owned entrepreneurship with the global and national financial markets.

The appetite of US and European private equity investors for the Italian market experienced a slowdown in Q1 and Q2 2020, mainly due to the COVID-19 outbreak, which brought uncertainty to the overall economic situation. On the other hand, the last semester of 2020 was characterised by a fast recovery of the market and the important role of domestic firms and industrial players with reorganisation and consolidation goals (especially in the financial sector) and injection of venture's monies. The Italian private equity is and remains robust and active. Looking at the data, according to AIFI, the Italian Private Capital Association, during 2020, approximately 471 transactions were completed (with an increase of 27% *vs* 2019). In making their investments in Italy, private equity firms usually preferred to acquire the control of a company rather than a minority stake either through: (i) the subscription of a reserved share capital increase – mainly when the target needs new equity to repay its debts or feed its development goals; or (ii) straight acquisitions of the controlling shareholding. Moreover, during 2020, approximately 81 divestments have been completed, mainly made through trade sale mechanisms (35), followed by founders' and sellers' buy-back, secondary buyouts and, to a limited extent, by IPOs, with the remaining divestments carried out through sales to other investors, entities or family offices, or write-off.

During 2020, there were no major changes in the implementation of the structure of private equity transactions in the Italian private equity arena and firms continued to use in the structuring of their investments a combination of equity, quasi-equity and debt. However, some trends and features (already in place in 2019) can be highlighted: (i) a relative increase of sale auction processes with fierce competition between financial sponsors and strategic/corporate investors; (ii) co-investments, club deals or "consortia" between private equity firms or between private equity firms and strategic investors are becoming more common in Italy, in particular with regard to large or mega buyout deals, in order to combine their technical skills and financial capability against a new challenging economic environment; (iii) a remarkable increase in the execution of warranties and indemnities policies within the context of buyout transactions; (iv) increasing re-investment(s) by the seller/founder(s) of the target alongside the private equity investors in the special purpose vehicle; and (v) a relative increase in private investment in public companies ("**PIPE**") transactions, while take-private transactions are still infrequent in the Italian market also due to the characteristics and number of Italian listed companies.

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

The Italian private equity landscape is generally considered by global, European and domestic private equity firms an attractive market characterised by a large number of potential primary transactions, relatively few sale auction processes and a vast spectrum of appealing targets at more advantageous valuations than other, more mature private equity markets.

More specifically, the Italian corporate and economic market, which is the second European manufacturing powerhouse, includes a multitude of small, mid and large globally successful family-owned companies (few listed ones) with a particular focus on exports and international markets and active in highly specialised sectors, with skilled and highly trained personnel. The "Made in Italy" brand plays a pivotal role, too.

Therefore, the Italian market represents a fertile land for global and European financial sponsors that focus their investment appetite mainly on mid-size and large private companies as well as some listed companies. By contrast, Italian private equity firms usually focus their investments on the mid-market sector. Both clusters of investors are more active in the regions of North and Central Italy. In particular, in 2020, the North of Italy was the main relevant investment area (specifically, the Lombardy region and the city of Milan attracted 31.5% of the investments) and several private equity actions were carried out in Central Italy, while the South of Italy recorded only few investments.

Moreover, with respect to the factors that may encourage private equity transactions, it is worth emphasising that, due to the current social and economic circumstances triggered by COVID-19, the Italian government set forth a National Recovery and Resilience Plan, mostly financed by the European recovery plan known as "Next Generation EU", which should involve funds for more than EUR 220 billion over the 2021–2026 period to boost a transformational economic change of Italy, focused on the environmental, social and financial sustainability.

In light of the above, the above-mentioned five-year period (which is the average period of a buyout investment) might be decisive for Italy, not only to fully recover from the economic crisis due to the pandemic but also to reset its political and economic institutions having as main objects: (i) the public economy handling; (ii) the public administration and civil service red-tape bureaucracies; (iii) the architecture and culture of the legal and justice system, as well as the judiciary offices; (iv) the enactment of new legislation and simplification of the existing one; (v) the competition; and (vi) the taxation system.

On the other hand, the uncertainties in the efficiency of some Italian courts and public administration red-tape are considered by most investors the main factors currently limiting the amount of foreign direct investment ("**FDI**") in Italy, including private equity.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

Following the trends recorded in the last months of 2020, the first quarter of 2021 registered a robust increase in private equity transactions, with 66 deals already executed, the majority of which were buyouts.

From the available data, it seems that the first quarter of 2021 saw an increase of the average of the deal values (the highest registered in the last 20 years) and a good balance of global and national private equity players operating in the Italian market.

The transactions, driven also by the so-called environmental, social and governance ("**ESG**") factors (which have become increasingly significant in order to identify new investments), covered all sectors of industry and services, confirming the intense activity of the financial buyers during these first months of 2021.

There is a positive attitude towards private equity activity in Italy for the remaining months of 2021, which might be recalled as one of the most significant years for the private equity sector in Italy.

As already stated at question 1.2, the Italian government has envisaged economic and financial reforms in order to mitigate the pandemic's impact on the Italian financial landscape as well as increase the protection towards specific sectors and activities defined as "strategic" for the country. Such reforms are having a strong impact on the overall Italian M&A, including private equity activity.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

The Italian market saw the recent appearance of global private equity conglomerates (formerly pure hedge funds), which usually have a more short-term approach and less interest in direct governance powers or rights than the typical private equity investor active in the Italian market, as well as other new types of strategic and financial buyers, *e.g.*, pension funds, family offices and sovereign wealth funds.

In addition, the Italian market also experienced the rise and activism of small private equity investors (club deals and other informal investors), as well as venture capital players thanks to a favourable new legislation.

Within the current market landscape, the so-called Special Purpose Acquisition Company ("**SPAC**") represents a relatively new type of investment "tool" in Italy. Such vehicle, incorporated by a team of experienced sponsors, collects risk capital through an IPO with the purpose to acquire – and, ultimately, aggregate through the so-called "business combination" – an operative target that will then be listed. Upon completion of the business combination (which will generally occur within 16–18 months from the incorporation of the SPAC), the vehicle disappears.

Notwithstanding the above, in 2020, the Italian market registered a slowdown of SPACs investments, due to the difficulties faced by the overall capital market sector. However, it seems that, in 2021, SPACs investments have played a more active role, with several incorporations of vehicles already registered in the first months of 2021.

2 Structuring Matters

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

Private equity investors traditionally operate through *ad hoc* structures, which can include a foreign (typically EU) so-called HoldCo, and sometimes also a so-called MidCo, but the actual number of entities and their layers depends mainly on financing, tax and governance needs. The direct acquiring company, however, is generally a newly incorporated Italian company ("**NewCo**") in the form of a joint-stock company limited by shares ("**S.p.A.**") or a limited liability company ("**S.r.l.**").

In the event that managers want to participate in the envisaged investment, they may acquire a minority stake in a NewCo or its parent company, directly or through another corporate entity. Management investment is particularly encouraged by private equity firms in Italy since it guarantees continuity of the business and full commitment of key persons.

For additional thoughts and details, please refer to sections 8 (Financing) and 9 (Tax Matters).

2.2 What are the main drivers for these acquisition structures?

Private equity acquisition structures are driven by tax and financing reasons, as well as some ownership issues. For further details, please refer to sections 8 (Financing) and 9 (Tax Matters).

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

As anticipated, private equity transactions are usually implemented by a NewCo whose corporate capital is owned – directly or indirectly through a MidCo – by a HoldCo. When the private equity fund allows management investment, usually managers participate with a small stake either in the target company, the NewCo, or the MidCo.

Carried interests are an important instrument to incentivise managers to perform, and it aligns their interests with those of the investors. The carried interests represent a share of the profits of the investment – embodied into a financial instrument – that managers receive as compensation if a targeted "threshold" return of the investment is achieved (the "*hurdle rate*"). Usually, the relevant instrument also provides for little or no governance rights and limitations on transfers. For further considerations on carried interests, please refer to section 9 (Tax Matters).

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

In case of minority investments, private equity firms – like all investors – typically seek: protections, such as veto rights/super majority provisions on certain matters (*e.g.*, extraordinary transactions, transactions with related parties, strategic decisions, etc.); the possibility to have "watching dogs" in the board of the target – or sometimes, to designate one/two director(s); preference rights on distributions and liquidation; and specific information rights on the activity of the management body of the company (with detailed quarterly or semi-annual reports).

Furthermore, minority investments entail trust in the seller who, usually, continues to manage – directly or through his/her managers – the company's business and, as a consequence, they require his/her commitment to the company for a certain time period. Therefore, it is common to see minority investors also negotiating share transfer limitations (such as lock-ups or tag- and drag-along clauses). To that end, shareholders' agreements (and by-law provisions) play a fundamental role.

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 is generally a small minority of the corporate capital of the target or NewCo (around 5–10% of the ordinary shares). However, should the target be a "family-managed" company, the equity allocated to the management could be higher. It is not unusual to negotiate a call option on the remaining shares in favour of the investor or a put option in favour of the management, which can be triggered upon occurrence of certain agreed events (including good or bad leaver events).

Management's ownership is also usually subject to lock-ups and other share transfer restrictions and non-compete undertakings.

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 concepts are generally taken into account to calculate the price of the management shares in case of departure of the manager.

The most common events of good leaver are death, mental/physical incapacity preventing the manager from continuing his office, retirement, and revocation without cause.

On the other hand, any case of revocation with just cause (*giusta causa*) usually represents a bad leaver event, in addition to other specific events negotiated by the parties. Bad leaver events usually determine a discount on the market price of the management shares.

3 Governance Matters

As a preliminary overview, it is worth noting that Italian companies are allowed to choose among three different models of corporate governance. In particular, according to Italian law, the company's governance can be structured as follows: (i) the one-tier system, deriving from the Anglo-American tradition, in which the shareholders' meeting appoints the board of directors, which then appoints some of its directors to a management control committee entrusted with monitoring functions; (ii) the two-tier system, which owes its basic structure to the German tradition, without the involvement of the relevant workers/employee of the company, where the shareholders' meeting appoints a supervisory board, which then appoints a management body; and (iii) the so-called "traditional Italian model" in which the shareholders' meeting appoints both a management body and a control body.

Notwithstanding the option to choose among three different systems of corporate governance, it should be highlighted that, based on the available data, the two "alternative" models under (i) and (ii) above have been adopted only by four Italian listed companies (at the end of 2020, based on no. 228 companies listed on the Italian stock exchange market (*Mercato Telematico Azionario*), only three companies adopted the one-tier system and only one chose the two-tier system) and, also with reference to unlisted companies, the traditional model is the most widely adopted. In light of all the above, the answers below only make reference to the traditional model.

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 for private equity portfolio companies depend on the type of investment. For instance:

(i) in case of minority investments, refer to the answer under question 2.4; and
(ii) in case of majority investments, governance arrangements mostly relate to the full operational management of the target. By contrast, minority shareholders would usually seek veto/super majorities for material decisions, including the possibility to designate at least one director of the board.

In Italy, there is no obligation to disclose and/or make available shareholders' agreements, save for listed companies. However, in case corporate arrangements are also reflected in the by-laws of the target, those arrangements will be publicly available (since by-laws of companies are publicly available in Italy and can be easily extracted from the Italian Companies' Register).

It is worth mentioning that, especially for joint-stock companies (whose regulation is less flexible than the regulation provided for limited liability companies), certain governance provisions agreed by the parties in a shareholders' agreement cannot be mirrored into the by-laws of the company. Also, the main difference is that while shareholders' agreements are enforceable only towards shareholders who are party to the agreement (*efficacia obbligatoria*), by-laws provisions are also enforceable *vis-à-vis* third parties (*efficacia reale*); such difference plays an obviously important role in the event of violations.

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?

Unless the by-laws of a private company contain supermajority provisions at shareholders' level and/or board level, resolutions are taken by simple majority.

Generally, a private equity investor (directly or through the designated director(s)) acquiring a minority stake would seek veto rights/supermajorities on all major corporate decisions of the target either at the shareholders' level (such as extraordinary transactions, liquidation, amendments of the by-laws, capital increases, etc.) or at the board of directors' level (strategic decisions, related party transactions, important financial matters such as approval of the business plan, etc.).

Should a private equity investor acquire a controlling stake, the veto/supermajorities above are usually sought by the minorities.

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 limiting the effectiveness of veto rights. Veto rights are usually provided in shareholders' agreements, enforceable as contractual obligations binding upon the contractual parties, unless they are also reflected in the by-laws – to the extent permitted by the law. However, in order to avoid serious and continuous deadlock situations (which could lead to the impossibility for the company to operate and continue pursuing its corporate purpose and, in certain extreme cases, to its dissolution), escalation procedures may be agreed by the parties. The ultimate deadlock resolution mechanism is the so-called "Russian roulette" or "shotgun" clause. This clause, which forces a shareholder to either sell its participation or acquire the participation of the other shareholder, in both cases at the price determined by the proposing shareholder, has been widely debated among Italian scholars and, recently, its validity has been confirmed by the decisions of two important Italian courts. It is worth mentioning that although such clause was not new in the Italian legal framework, its validity was specifically analysed by the Italian case law for the first time only in 2017, when the Court of Rome was called to decide upon the validity of a Russian roulette clause inserted in a shareholders' agreement. The Court of Rome declared the legitimacy and validity of the clause. Such decision was subsequently upheld by the Court of Appeal of Rome (decision dated February 3, 2020).

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?

Equity investors have no particular obligations towards minority shareholders. However, in taking any corporate resolutions, the majority shareholder shall always act in good faith and pursue the corporate benefit. The majority shareholder shall not take advantage of its position (*abuso di maggioranza*). Therefore, a resolution directed only to the benefit of the majority shareholder (and to the detriment of the minority shareholder) with no corporate benefit for the company could be challenged in court for annulment (in certain cases, the minority shareholder is also entitled to receive liquidated damages).

It is worth mentioning that minority shareholders shall not abuse their position (for instance, in case the by-laws of the company provide for a veto right/supermajority in favour of the minority shareholders) or act to their sole benefit or in prejudice of the interest of the company (*abuso di minoranza*).

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 Italian law, the duration of shareholders' agreements is subject to certain time limits. In particular:

- with respect to joint-stock companies (*società per azioni*), save in case of *joint ventures*, the duration of a shareholders' agreement shall not exceed a five-year term; and
- with respect to limited liability companies (*società a responsabilità limitata*), contrary to joint-stock companies, there is no such time limit; however, the shareholders enjoy a termination right at will.

Furthermore, according to Italian law, holders of the same type (category) of shares should enjoy similar rights; therefore, it is common for joint-stock companies to provide for different categories of shares that vest different rights. This principle does not apply for limited liability companies, whose corporate capital is represented by quotas (and not by shares) and whose regulation is more flexible.

With regard to non-competition provisions contained in a shareholders' agreement, such provisions shall be limited both in terms of time and geographic area or activities.

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?

First of all, directors must be entitled to serve and not fall into one of the prohibited categories set out by the law. Directors of Italian joint-stock companies can be appointed for a maximum three-year term, while no such limit applies to limited liability companies.

The by-laws of the portfolio companies could also provide for specific requirements to be met by directors. Moreover, for certain types of companies (those subject to regulatory control, such as banks and insurance companies), directors and top managers shall meet further requirements provided by applicable law (in terms of reputation, professionalism and independence).

The risks and liabilities of directors designated by a private equity investor are exactly the same of directors designated by any other shareholder. Directors shall carry out their offices: (i) in accordance with applicable law and the company's by-laws, to pursue the company's corporate purpose and in compliance with the corporate benefit principle; (ii) with the diligence required by the office and based on their respective specific skills and knowledge; (iii) in an informed manner; and (iv) not acting in conflict of interests with the company. On the other hand, directors are protected by the "business judgment rule" principle.

Directors may be liable towards (a) the company, (b) the company's creditors, and (c) the company's shareholders or third parties.

Furthermore, it is worth mentioning that a shareholder could potentially be held liable for the underlying portfolio companies if its exercise of the "direction and coordination" activity over the controlled companies causes damages or losses to such companies. The "direction and coordination" activity over the controlled companies is presumed upon occurrence of certain conditions, such as the presence of the same members of the management bodies in both the directing company and of the controlled company, the steady stream of instructions that the directing company gives to the controlled company's directors. Please also refer to the answer to question 10.5.

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 Italian law, there is no conflict of interest *per se* if a director is designated by a shareholder or in case a director sits on the board of different portfolio companies.

The above being said, a director shall always act in the interest of the company he/she serves, in order to pursue its corporate purpose and in compliance with the corporate benefits principle. As a matter of fact, unless specifically authorised by the shareholders' meeting, directors cannot (i) be shareholders of competing companies with no liability limitation, (ii) operate a competing business, or (iii) hold the office of director or general manager in competing companies.

When a director is in a conflict of interest (on his/her or a third party's behalf) with respect to the adoption of a certain corporate resolution, he/she shall declare and explain such conflict before the vote. A resolution passed with the decisive vote of a conflicted director can be challenged by the other directors or statutory auditors if such resolution causes damage to the company. In certain cases, the conflicted director should refrain from voting (for instance, in case the resolution concerns the director's liability).

4 Transaction Terms: General

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

The major issues impacting the timetable for transactions in Italy are those regarding antitrust and/or regulatory authorisations/approvals/clearances, as well as the completion of unions' procedures. In addition to the foregoing, Law Decree no. 23/2020 (the "**Decree**") introduced new rules that significantly strengthened the **FDI** screening regulation (so-called "golden power" regulation), including a provisional regime for the COVID-19 emergency. In particular, the Decree, as well as its implementing governmental Decrees (*i.e.*, D.P.C.M. no. 179/202 and 180/2020), significantly widened the scope of the activities and assets qualified as "strategic" under an FDI perspective, and also with respect to the following sectors: defence and national security; energy; transport; telecommunications; water management; health; management of sensitive personal data; electoral infrastructures; finance, banking and insurance; certain critical technologies and infrastructures of "hi-tech" sectors (*e.g.*, dual use, robotics, artificial intelligence, semiconductors, cybersecurity, etc.); steel industry; food safety; media and pluralism.

In addition, the Decree introduced a temporary regime providing that, until December 31, 2021, the following transactions are subject to foreign investment filing:

- any resolution and transaction adopted/entered into by any EU or extra-EU entity holding strategic assets resulting in change of control or ownership, or of use with respect to the assets/businesses indicated above;
- any acquisition of shareholdings, by any EU or extra-EU entity, in companies holding strategic assets resulting in a change of control of the target company; and
- any acquisition of shareholdings, by any extra-EU entity, in companies holding strategic assets resulting in the acquisition of at least 10% of share capital or voting rights, provided that the total investment value is equal to or higher than EUR 1 million. Such acquisitions will be also subject to communication whenever the holding thresholds of 15%, 20%, 25% and 50% are exceeded.

The Decree also entitled the government to commence *ex officio* the procedure to assess the exercise of the golden power (in case of failure to report a transaction).

The extension of the scope of the FDI regulation triggered a relevant increase in the transactions notified, even for mere precautionary purposes.

In particular, the 2020 Annual Report about Security shows that, in 2020, 341 notifications have been carried out, of which 140 have been declared as not subject to such regulation. The special powers were exercised only in 37 cases, the majority of which referred to 5G technology. No veto was exercised in 2020 by the Italian government but, in April 2021, the latter notified the prohibition for a Chinese investor to purchase an Italian company manufacturing semiconductors (it is the second case of veto over an M&A transaction since 2012).

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

Please refer to the answers to the questions above (in particular, section 1).

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 Italian economy boasts a relatively limited number of listed companies: no. 325 companies are listed on the MTA, *i.e.*, the Italian regulated main market – and no. 138 companies are listed on the AIM Italia (both figures as of December 2020). Public M&As in Italy have been relatively active in 2020 and in the first quarter of 2021.

With reference to applicable laws, Italian public-to-private deals are governed by the Italian Civil Code ("**ICC**"), the Legislative Decree no. 58 of February 24, 1998 (the "**Consolidated Financial Act**") and the Issuers' Regulation no. 11971 of May 14, 1999, issued by the National Commission for Companies and the Stock Exchange ("**CONSOB**") (*i.e.*, the Italian authority regulating and supervising companies listed in Italy and Italian securities markets, including public-to-private deals) in order to implement the Consolidated Financial Act provisions at a secondary level. Furthermore, the rules and regulations issued by Borsa Italiana running the Italian securities market on the Milan Stock Exchange, and the EU Regulation no. 596/2014 (the "**Market Abuse Regulation**") and the related EU delegated regulations are also applicable.

More specifically, the control of an Italian public company can be acquired in several different ways including, without limitations, by: (i) launching a voluntary tender offer over the public company's shares; (ii) acquiring the "controlling" stake through a share purchase agreement entered into with the majority shareholder(s), which implies the launching of a mandatory tender offer over all of the public company's shares; and (iii) subscribing to a capital increase of the listed company. Tender offers and capital increases are supervised by CONSOB.

It should be pointed out that the trend of investments carried out by means of a business combination between unlisted companies and listed SPACs is increasingly widespread in Italy.

Subject to the Consolidated Financial Act and Market Abuse Regulation, a prospective bidder may generally build a stake in the target public company's share capital before the acquisition of its control. However, a careful valuation and an in-depth analysis should be made prior to any stakebuilding activity to be made before the launch of a tender offer in case such shareholder has taken the decision (not yet publicly announced to the market) to launch a voluntary tender offer over the target in order to make sure that such stakebuilding activity does not raise issues under the Market Abuse Regulation.

Due diligence exercise carried out over an Italian public company shall be carried out in compliance with the provisions of the Market Abuse Regulation.

In case of a tender offer, one of the main hurdles is represented by the regulatory approval of the offering document by CONSOB. Where the tender offer is classified as "voluntary" (Art. 102 and ff. Consolidated Financial Act), the offeror enjoys a broader grade of flexibility in setting out the T&Cs and the price of the transaction; by contrast, in case of mandatory offers (Art. 106 and ff. Consolidated Financial Act), the offeror shall abide by the T&Cs of the bid set out by the law and enjoys less freedom regarding the determination of the consideration. Indeed, if in a voluntary offer the consideration may be represented by cash, existing or new shares or other securities (*e.g.*, convertible bonds or warrants), or even a combination thereof, in case of a mandatory takeover, the bidder shall offer cash payment as an alternative (where the offer encompasses securities that are not traded on an EU regulated market).

In the case of takeover bids, the bidder's communication to be filed with CONSOB shall comply with some special disclosure requirements concerning, for instance, the offeror and its controlling entity, the number of securities to be purchased, the consideration offered, the reasons for the offer, the conditions to which the offer is subject and, if any, the clearances needed. The offeror may submit the communication only after having obtained the necessary financing for the offer. The most important elements of the bidder's offering document include the guarantees for the offer, the financial statements regarding the offeror, and the strategic plans of the offeror on the target. CONSOB is the authority in charge of approving all offering documents. The approval by some other competent supervising authorities (*e.g.*, the European Central Bank, Bank of Italy, or Insurance Supervisory Authority ("**IVASS**")) may have to be requested, depending on the field of business in which the target operates. Italian and/or European Antitrust Authorities' clearance may also be required in the case of regulated industries or a merger leading up to a potential concentration. Furthermore, CONSOB should also be provided with all necessary documentation relating to the guarantees at least one day before the date of publication of the offering document, and the bidder has to provide evidence that the consideration is available before the acceptance period starts.

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

Voluntary tender offers (but not mandatory tender offers) may be subject to conditions precedent (*e.g.*, minimum threshold of acceptance, obtainment of authorisations such as antitrust/golden power, etc.), provided that the satisfaction of such conditions precedent does not depend on the offeror's mere will (so-called *condizioni potestative*). In private equity transactions, the material adverse change ("**MAC**") conditions are also very popular. Their importance increased with the outbreak of COVID-19.

A common deal protection condition on which both the bidder and the target could agree upon is a break-up fee. Usually set out in the letter of intent or other preliminary agreement, it provides for an indemnification that shall be paid by the party who breaks off the negotiations without reasonable cause. The parties may also provide for an exclusivity agreement and the target's shareholders may approve a resolution in order to issue shares or sell assets to support the preferred bidder, jeopardising any intervention by a competitor. The target's shareholders can even commit themselves to tender the shares in the offer process.

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 last few years, many private equity transactions have been carried using the locked-box mechanism. The value and use of such consideration structure is dependent upon various elements, such as: (i) the time running between the date in which the investor prices the company (usually through a reference statement, which is also subject to specific and strong warranties delivered by the seller) and the closing of the transaction; (ii) the type of financial document produced by the company/seller that the investor uses to price the business (audited financial statements *vs* financial statements *vs pro forma* balance sheet, and so on); (iii) the standing of the subject certifying or auditing such document; and (iv) the stability of the business involved (which can change materially over a short timeframe). Any difference in the relevant figures between the date in which the buyer "locked the box" (the so-called "locked-box date") and the closing date is usually treated as leakage, with certain exceptions to be agreed upon in the course of the negotiation (the so-called "permitted leakages").

The above being said, sellers typically prefer an earn-out structure consideration (which gives value to their continuing presence in the company after the sale), while buyers are more comfortable with the closing accounts structure and, to a lesser extent, the locked-box mechanism (which somehow gives certainty to the purchase price and the business acquired).

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

All sellers (especially private equity sellers) generally tend to offer a very limited package of representations and warranties: the commonly accepted representations and warranties are the "legal ones" (those referring to the ownership and title over the shares of the company subject to transfer) usually accompanied by certain limited business warranties, such as tax and labour representations and warranties. The standard duration for business warranties is up to 12–18 months.

The representations and warranties of the management tend to be aligned.

In common practice, private equity sellers deliver fewer representations and warranties than an "ordinary" seller and tend to negotiate a very small indemnification cap (around 10–20%); uncapped indemnities are not usually accepted by private equity sellers.

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?

When the transaction envisages a separate signing and closing, interim covenants are usually provided. Interim covenants ensure that, during the period running from signing to closing (the so-called "interim period"), the target's business is not subject to material alterations with respect to the one evaluated (and priced) by the potential buyers and it is carried out in a manner consistent with past practice. Anti-leakage provisions are common too, especially if the parties agree on a locked-box consideration structure.

In certain cases, private equity sellers may also grant indemnities in relation to specific issues identified by a potential buyer during its due diligence activity in order to mitigate any impact such issues might have on the purchase price previously agreed upon by the parties (*e.g.*, in a binding offer).

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 warranty & indemnity insurance ("**W&I insurance**") used to be very rare in Italy due to the high premiums requested and the necessity to carry out a very detailed (and expensive) due-diligence exercise, as required by the insurers. However, in recent years, the trend has seen some changes, and private equity players are now much more interested in W&I insurance, which are offered by many insurers (usually through brokers).

W&I insurance policies do not cover issues identified during the due diligence process or arising from matters that have not been properly assessed or inspected in the due diligence and, of course, do not cover price adjustments. In addition, such policies do not offer coverage for certain business representations and warranties, such as environmental, compliance with law (anti-corruption), secondary tax liability, sanctions, product liabilities, balance-sheet projections, etc.

The cost of such policies depends on the indemnification cap, on the coverages sought and on other factors (such as *de minimis*, basket and so on).

It is worth mentioning that while nowadays these policies are often adopted in real estate transactions, their use in corporate transactions is still relatively limited, even though private equity players are getting more and more comfortable with them – certain private equity players also require the execution of "flip-to-buyer" W&I insurance as part of the transition package. The advantages of executing W&I insurance are still debated, mainly due to: (i) the articulated process necessary for their execution – the buyer shall indeed negotiate the representations and warranties not just with the seller, but also with the insurer (especially if the parties agree that the seller would cover certain representations and warranties not covered by the policy); (ii) the (still) considerable costs, also considering that (1) the buyer shall bear the costs of the legal advisors of the insurer, and (2) certain insurers also request a break-fee; (iii) the relatively limited coverage offered (see above); and (iv) the very little room that insurers leave to negotiation.

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' indemnification obligations are always subject to (a) limitations: cap (around 10–20% of the consideration agreed); basket (around 10–20% of the cap); and *de minimis* (which is typically expressed by a number, the greater the better for the seller), and (b) exclusions, such as losses resulting from change of laws after the closing, events disclosed in the context of the due diligence (where not subject to specific indemnities) or caused by an action or omission of the potential buyer. Time limitations for general representations and warranties are in a range between 12–18 months. Private equity sellers do not usually deliver fundamental representations and warranties (usually requested by a buyer for environmental, labour and tax matters) or special indemnity 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)?

In case of execution of W&I insurance, private equity sellers do not generally provide any additional security. In the absence of the above policy, a corporate guarantee is generally released by the parent HoldCo (or by another company of the private equity seller's group).

Private equity buyers, on the other hand, usually request bank guarantees or the execution of escrow agreements to cover (all or part of) the indemnity cap with part of the purchase price pre-adjustment(s). The duration of the escrow usually mirrors the duration of the guarantees.

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 buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

A private equity buyer typically delivers to the seller an equity commitment letter that commits the guarantor/sponsor (part of the buyer's group) to provide the necessary funds to close the transaction or fulfil any other buyer's monetary obligation towards the seller. Equity commitment letters usually contain the right of the seller to trigger the guarantor's obligation to provide equity, upon occurrence of certain conditions (and failure of the buyer to do so).

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 the Italian market.

A break-up fee could be negotiated (but would rarely be accepted by a sophisticated seller) in the preliminary documentation of the transaction. For instance, a break-up fee can be established for the reimbursement of the due diligence costs suffered by the potential purchaser in the event of the seller's unjustified interruption of the negotiations or wilful misconduct.

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 phase is the most important for the success of a private equity investment. Exits through IPOs are often at higher multiples and at a closer market price than exits through third-party sale transactions. For these reasons, IPOs represent one of the main strategies of divestment for private equity sellers. However, exits through IPOs are subject to volatility and present other significant pitfalls. Therefore, as foreseen by the relevant Italian and European legislation (in particular, Regulation (EU) no. 2017/1129 of the Parliament and of the Council, as amended and integrated by Delegated Regulation (EU) no. 2019/980 of the Commission), the IPO prospectus contains an extensive and detailed section dedicated to risks. Usually, the prospectus distinguishes between the characteristic risks of the issuer, those linked to the sector to which it belongs and those relating to the operation itself of listing the company on the stock exchange.

Moreover, from a corporate governance perspective, the IPO process requests a sort of "transformation" of the private company into a public corporation; this usually implies an internal reorganisation, also in terms of governance, in order to allow the company to comply with the rules provided for listed entities.

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

Although the lock-up period varies on a case-by-case basis, Joint Global Coordinators usually request the sellers to abide by a lock-up period ranging from three to 12 months (starting from the IPO date). It should also be noted that the lock-up period is usually longer for SPAC IPOs, where the lock-up usually lasts until the business combination (which will generally occur within 16–18 months from the incorporation of the SPAC) is completed.

Lock-up periods are not mandated by the Italian legislation or any other regulatory body, but they are either self-imposed by the company going public or required by the investment bank underwriting the IPO request. In either case, the goal is the same: to keep stock prices up after a company goes public.

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 dual-track process is usually pursued by private equity funds. The decision to proceed with a sale or the IPO is usually taken before the approval by CONSOB of the prospectus and ultimately depends on the price offered by the potential buyers and capital market conditions.

A dual-track exit process is usually functional to maximise the price paid to the seller(s), leading to more favourable T&Cs and assuring a greater level of execution certainty.

Dual-track strategies depend also on the portfolio company's size. Small and mid-size portfolio companies, indeed, are less prone to spend resources to concurrently prepare for both an IPO and a third-party 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).

The structure of the financing of private equity acquisitions in Italy largely depends on the size of the transaction. In the mid-cap market, deals are generally financed through senior bank loans provided by a pool of banks or, for higher amounts, syndicated loans. The number of transactions financed by means of bond issuance (in the form of mini-bond or corporate bond) and the recourse to vendor loans is also growing.

However, in larger transactions, acquisitions are also frequently financed through a combination of senior and mezzanine debt or senior debt and bonds. Financing can include senior term and revolving debt, first and second lien debt in the form of loans or notes, mezzanine term debt, payment-in-kind ("**PIK**") loans or notes and vendor financing.

Furthermore, high-yield market is a viable source of acquisition financing; the related corporate structure, similarly to bank financing, may contemplate senior and subordinated debt components through the issuance of different types of notes, with senior secured notes eventually becoming structurally senior to the subordinated notes. Despite this, the number of acquisitions entirely funded through a high-yield bond issuance is still limited in the Italian market, but we expect a considerable increase of acquisition bond financing in the near future, in particular by means of a combination of bridge to bond senior financings granted by the arrangers for the purpose of completion of the acquisition closing and their refinancing through bond issuance.

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 main Italian law restrictions involve financial assistance and corporate benefit issues.

Financial assistance requirements restrict Italian companies from directly or indirectly providing financial support (including in the form of granting security to acquisition lenders) to buyers in the purchase of its shares. Any loan, guarantee or security given or granted in breach of these provisions is null and void.

Although in certain cases a whitewash procedure is achievable for targets to provide immediate support in acquisition financing, generally speaking in the context of leveraged buyout ("**LBO**") transactions, any financial assistance restriction would cease to apply upon perfection of a merger between the NewCo/BidCo and the target made in compliance with Italian law provisions related to LBO mergers (which also impose to follow a specific procedure contemplating a debt sustainability test at the level of the combined entity).

In market practice, to avoid any financial assistance issues, acquisition financing is commonly structured in a combination of short-term debt granted to the NewCo/BidCo (and having a maturity in line with the envisaged timing of the merger) and long-term financing (aimed at refinancing the short-term financing at the level of the combined entity). In turn, in less complex deals, long-term financing may also be granted from day one, which will provide an early termination in case the merger is not completed by a fixed longstop date (usually set six to 12 months following the closing).

In the first phase of the financing (until merger), the acquisition debt is likely to be supported only by means of a share pledge over the NewCo and the target (as well as by further security at the level of NewCo). In the second phase (*i.e.*, upon merger), in addition to the share pledge over the merged entity, the financing takes usually benefit from security interests created over significant assets of the combined entity.

Corporate benefit requirements impose that Italian companies, providing upstream and/or cross-stream security interests and guarantees in the interest of their parent company financing, obtain a direct or indirect tangible benefit from the secured transaction. The existence of a corporate benefit for an Italian entity is ultimately a matter of fact – rather than a legal concept – to be carefully evaluated by the management of the relevant Italian guarantor, and the guaranteed or secured amount must not materially exceed the financial capability of the Italian guarantor. The market practice has elaborated some solutions for helping directors in evaluating the existence of corporate benefit and its "translation" in the relevant financing documentation (such as, for instance, limiting the maximum amount guaranteed by an Italian subsidiary to the amount of intragroup debt received by it). Nevertheless, the existence of the corporate benefit must be evaluated on a case-by-case basis.

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

At the beginning of 2021, the expectation in relation to deal activity was robust thanks to the abundance of liquidity provided by banks and the huge number of alternative lenders that entered the market (also thanks to recent reforms that provided new rules that expressly allowed EU alternative investment funds ("**AIFs**") to "invest" in loans (where "invest" includes also origination), subject to certain conditions, and a new favourable tax regime for foreign investors), as well as very positive borrowing conditions in terms of leverage, pricing and fees, plus the introduction of a whole range of new structures. Among them, it is worth mentioning, in the context of senior acquisition loans in the Italian market, the unitranche loans. In any case, despite the influx of alternative lenders, traditional banks continue to play a major role in the Italian market. Indeed, looking at survey results, senior-only structures are the most common mid-market 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?

Different key tax and structuring considerations may come into play depending on the type of acquisition (minority *vs* 100% or listed company *vs* private).

In all circumstances, given the fairly significant amount of taxes still applicable in Italy on interest, dividends and capital gains (generally at 26%), special attention is devoted to efficient tax structuring in order to manage those charges. Intermediate foreign (typically EU) holding or finance companies generally play an important role in this attempt. One key aspect is always ensuring maximum deductibility of interest expenses in combination with no interest withholding tax on payments to lenders. Of course, repatriation of dividends or capital gains on exit free from withholding tax are also key factors when structuring the acquisition in order to maximise return from the investments.

Recent amendments to the Italian legislation introduced a total exemption on dividends and capital gains realised by EU-based AIFs, thereby making investments in Italian targets much simpler and more efficient for those entities.

Italy is one of the few countries that introduced measures to incentivise capitalisation of companies *vs* leverage through the granting of a notional interest deduction ("**NID**"). Maximising the effect of the NID while still maintaining deductibility of the interest on the acquisition financing is key.

Another area of interest is management plans, to make sure their incentive schemes are designed to fit within the recently introduced beneficial carried interest regime.

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)?

Italy has only recently introduced a sort of safe harbour favourable carried interest regime, which, in certain circumstances (among which (i) minimum managers' co-investment equal to 1% of the value of the target, and (ii) minimum investment period), may ensure tax treatment as a financial investment (26%, as opposed to employment income tax treatment up to 43%) to investment instruments (preferred shares or other preferred financial instrument) providing "additional remuneration" above a certain hurdle rate compared to ordinary equity investment. If the safe harbour requirements are met, the more beneficial tax treatment will be guaranteed even if a clear link exists between the employment position and the entitlement to the "preferred remuneration".

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?

Much depends on the actual co-investment scheme but in general, when simply selling their co-investment, management teams will seek where possible to enjoy a particular tax scheme that allows an increase in the value of the investment by paying an 11% tax on the full fair market value of the instrument. Subsequent sales would be carried out without realising any chargeable gain.

In the context of a possible reinvestment, to the extent that (i) terms and conditions of the "new" scheme are not materially different from the old one, and (ii) the purchaser is ready to cooperate, it is possible (although not common) under certain circumstances to obtain a roll-over of the management teams' scheme into a new acquisition structure without realising a chargeable gain.

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?

Historically, acquisition structures have been severely challenged by the Italian tax administration on the basis of non-deductibility of interest on acquisition financing. Since 2016, certain clarifications have been released by the tax authority that have provided a much more relaxed (tax) environment for most of the LBO transactions. It has been clarified that although the financing is not strictly linked to the target but is an acquisition financing, it will be deductible upon certain specific conditions. Similarly to other EU jurisdictions, interest will only be deductible within the 30% EBITDA interest barrier rule.

The current hot topics in Italian tax legislation are mostly connected to the recent changes in the EU tax system and connected attention to cross-border transactions. In particular, restrictions set forth in the implementation of the Anti-Tax Avoidance Directive ("**ATAD**") (including anti-hybrid rules) and the EU Directive on administrative cooperation ("**DAC 6**") need to be carefully addressed when structuring private equity deals.

As to the 2019 so-called "Danish" cases (concerning the beneficial ownership of EU-based holding structures and abuse of EU Parent-Subsidiary/Interest and Royalties Directives), the European Court of Justice's approach is mostly consistent with the long-standing aggressive position of the Italian tax administration. In other words, such cases cannot be deemed as significantly affecting the Italian tax system, but rather as confirming a sound approach as to substance/beneficial ownership tests of EU intermediate holding 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?

The main legislative development impacting private equity investors in recent years has certainly been the entry into force of Directive 2011/61/EU of the European Parliament and of the Council of June 8, 2011 on alternative investment fund managers ("**AIFMD**"), as fully implemented in the Italian jurisdiction in 2015.

In particular, the AIFMD, introducing the regulatory provisions for all non-UCITS investment fund managers ("**AIFM**"), provides for, *inter alia*: (i) rules prohibiting "asset stripping" by private equity firms in the case of an acquisition of control over a non-listed company having its registered office in the EEA (*i.e.*, the AIFM is not allowed, for a period of two years following the acquisition of control, to facilitate, support, instruct, or vote in favour of certain distributions, capital reductions, share redemptions and/or acquisitions of own shares by the relevant company, and must in fact use its best efforts to prevent any such transactions from taking place); (ii) the obligation for the AIFM to make certain information available to investors before they invest in the fund, including a description of the investment strategy; and (iii) the obligation for the AIFM to disclose, to the competent authorities as well as to shareholders and employees of target companies, information on the acquisition of control and their intentions on the future business of the company and repercussions on employment.

Moreover, it is worth mentioning that recent developments in the Italian anti-money laundering ("**AML**") framework will soon require all Italian companies to disclose to the Companies' Register the identity and relevant information on the beneficial owners of the companies. In this respect, it is worth mentioning that AML rules provide for potentially far-reaching definitions of "beneficial owner", which may also include investors of private equity funds holding significant percentages of fund interests.

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

Generally, Italian law does not set out any specific restrictions on the issue and transfer of equity interests, except for companies active in specific sectors where the authorisation of certain competent authorities may be required. Reference is made, in particular, to transactions involving banks and (re-)insurance companies as well as other financial institutions subject to the supervision and rigorous scrutiny of EU and national supervisory authorities (*i.e.*, European Central Bank, Bank of Italy, IVASS, CONSOB).

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 accuracy of the due diligence conducted by private equity players depends on several factors. Generally, the due diligence exercise is very detailed, in particular if the parties decide to execute a W&I policy (since a very detailed due diligence report would be requested by the insurer). In other cases, it can be carried out at a higher level. Of course, it varies case by case, also depending on the needs of the purchaser, the size of the target, and the type of investment.

If the target is sizeable, it is common for parties to agree on materiality thresholds, in order to avoid a long and expensive due diligence activity. The magnitude of the contractual warranties plays a fundamental role in such respect: if many material warranties are previously agreed, the potential buyer might be more relaxed in the due diligence exercise.

As per the timings, provided that it depends on the amount of documentation to analyse, three or four weeks might suffice to complete the due diligence.

In certain cases, an additional or confirmatory due diligence between signing and closing may be agreed upon by the parties and/or requested by the buyer, especially in the context of competitive procedures.

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 have a material impact on private equity investments in Italy, especially for certain types of acquisitions (*e.g.*, where the target operates in certain specific sectors or deals with the public administration).

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?

A private equity investor could potentially be considered liable for the underlying portfolio companies in case of its exercise of "direction and coordination" activity.

In particular, to be held liable, a company shall exercise direction and coordination activity and act in its own or another's business interest in violation of the principles of proper corporate and business management of the controlled company. The foregoing may expose the directing company to liability for damages towards the shareholders and creditors of the controlled company.

The above liability is excluded when the damage is non-existent in light of the overall result of the direction and coordination activity, or is entirely eliminated, also further to action taken specifically for such purposes.

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 Italian government – led by Mr. Mario Draghi, the former President of the European Central Bank at the time of writing – expects Italy's Gross Domestic Product to grow by 4.5% in 2021 and 4.8% in 2022. As mentioned in the previous sections of this chapter, it seems that the current economic reforms adopted by the new government may, on the one hand, boost a transformational economic change of Italy, triggering public investment, incentives for private investments, research and development, digitisation and innovation and, on the other hand, tackle the long-term structural weaknesses of Italy.

Such profound changes in the Italian landscape might result in a positive boost for its business environment and private equity activity, as already highlighted in the first quarter of 2021 and considering the positive outlook for the remaining part of the year.

Lastly, another factor to be taken into account by the private equity players in the Italian market is that the presence of global investors in the Italian private equity sector raised the bar on ESG factors. As a consequence, sector organisations, strategic and financial investors, and lawmakers are paying more attention to the ESG factors (with particular regard to the health of the employees and workers), which must be taken into consideration in performing an acquisition in Italy and must be covered by due diligence exercises as well as by the terms of the share purchase agreement.

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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?

The most common types of investments in Japan are venture capital, growth capital, buyouts, corporate restructuring investments, distressed investments, etc. One recent noteworthy feature of the market is that growth capital transactions have been increasing. Other recent trends include carve-out deals by large industrial companies and business succession deals with the owners/founders. As for buyout deals, the amount of investment in Japan is mainly in the tens of billions of yen range, while a few large-scale investments exceed 100 billion yen.

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

In Japan, business succession among small and medium-sized enterprises ("SMEs") has become an issue due to the declining birth rate. Thus, acquisitions associated therewith could be a significant factor in facilitating the growth of private equity ("PE") investments in the future. In addition, large industrial companies now tend to be selective in concentrating their businesses, causing an increase in carve-out deals. Furthermore, as ESG investments become increasingly important in Japan, investments in ESG-oriented companies are expected to become more prevalent in the future.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

The COVID-19 pandemic has led to the need for a telework environment in many companies, including SMEs, as well as increased internet sales businesses, which has increased interest in investments into DX, AI, and data businesses. Also, since many companies have experienced a downturn in business conditions due to the COVID-19 pandemic, they are now more interested in carving out unprofitable divisions. As to whether the coronavirus pandemic has led to an increase in corporate restructuring and distressed investments, especially in SMEs, the Japanese government has expanded its business capital assistance and lending to SMEs, and so corporate restructurings of SMEs have not increased as much as expected. As a result, there have been few increases in the number of investment projects for these companies. PE funds also tend to be reluctant to make new investments because of the need to negotiate with financial institutions and creditors due to the deteriorating performance of existing portfolio companies.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

In Japan, the presence of these groups is still not significant, unlike in the US and other countries, where pension funds and SWFs are the predominant investor groups. The majority of venture capital investors in Japan are domestic industrial companies, banks, insurance companies, and securities companies, with very few foreign investors.

2 Structuring Matters

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

A typical structure for a transaction in Japan is acquiring shares in the target company through an investment limited partnership called "Investment LPS" under the Limited Partnership Act for Investment ("ILPA") or a foreign limited partnership, such as one formed in the Cayman Islands. For acquisitions of Japanese domestic companies, deals using Investment LPS seem to be more common. For acquisitions of public companies, a two-step acquisition (i.e., the PE investor first launches a tender offer to acquire more shares of the target company, followed by a share swap to acquire the remaining shares) is often used.

2.2 What are the main drivers for these acquisition structures?

The main factors for choosing these acquisition structures include tax-efficiency, structuring costs, and the business to be invested in acquired. Acquisition structures using partnerships are preferred for tax purposes because they avoid corporate taxation. In addition, domestic investors prefer using Investment LPS as funds to invest in domestic companies because their formation and maintenance costs are lower than those of foreign limited partnerships.

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

The percentage of equity varies depending on the growth phase of the start-up and each transaction. For example, in buyout investments, investors often make a majority investment in the target company to acquire management rights and rebuild the business. On the contrary, in venture capital investments in their earlier stages, investors often make minority investments, and the management shareholders, such as the founders, hold the majority of a target company.

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

Minority shareholders must consider whether they should set out to have certain veto rights through class shares or shareholders' agreements for essential decisions concerning the target company's business. It is also necessary to consider whether there should be a right to obtain information concerning the target company and/or the right to participate in the target company's board of directors as an observer since such minority shareholders are not allowed to appoint directors under the Companies Act.

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 extent of equity allocated to management shareholders varies on a case-by-case basis. Nevertheless, in buyout transactions, PE investors are usually the majority shareholders, while management shareholders are the minority (less than 50%). Typical events for vesting or compulsory acquisitions include listing the target company's stock (IPOs) and, in recent years, compulsory acquisitions have taken place in connection with M&As, such as the transfer of the target company's stock or a merger thereof.

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

In buyout deals, although PE investors acquire the majority of a target company's shares, the management equity holder may remain with the target company for a certain period of time as an advisor to turn over the business of the target company to PE investors. If the management equity holder later leaves the target company amicably after such turnover period, or due to death or the inability to perform his/her duties, then he/she will be considered a "good leaver". However, if the director is forced to resign due to a breach of the duty of care as a director of the target company, then the director will 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?

With regard to the governance arrangements of the target company, special provisions are often set out in shareholders' agreements or class shares to ensure that the intentions of PE investors are appropriately reflected in the management of the target company. For example, shareholders' agreements and class shares often stipulate the right to appoint directors in proportion to shareholders' stakes and the right to veto important decisions concerning the target company. Shareholders' agreements are not disclosed to the public, while the terms of class shares are 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, as mentioned in question 3.1 above, PE investors often have veto rights with respect to important decisions concerning the target company's business through shareholders' agreements or class shares. Such veto rights often include amendments to the articles of incorporation of the target company, sale of its business, purchase or sale of its assets exceeding a certain amount, borrowing, etc., all of which affect its business. In addition, veto rights also include actions that affect the percentage of voting rights of PE investors, such as the issuance of new shares by the target 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?

In Japan, a contract is valid as long as its contents do not violate public order and morals. Therefore, if a shareholders' agreement provides a veto right, it would be considered valid as long as it does not violate public order and morals. However, if the veto right is established at the level of the director nominee, then such veto right may violate the director's duty of care to the company. Therefore, the veto right should be stipulated in the shareholders' agreement or as part of the terms of the class shares.

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 the laws of Japan, the PE investor itself owes no obligation to the minority shareholders. However, a director of the target company appointed by the PE investor owes a duty of care to the company under the Companies Act.

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 a shareholders' agreement complies with Japanese law, then it would be enforceable in Japan. Non-competition and non-solicitation obligations can also be stipulated, but in light of Japanese labour regulations, the period of such obligations is likely to be just two to three years.

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?

It should be noted that if the target company is engaged in any of the "Designated Business Sectors" defined under the Foreign Exchange and Foreign Trade Act ("FEFTA"), then a foreign investor must make a prior notification before giving its consent at a general shareholders' meeting to appoint itself or a "Closely-related Person" as defined under the FEFTA as a director of the target company. The key potential risk of directors nominated by a PE investor is the conflict between the duty of care to the PE investor, and that owed to the target company. If the director fails to comply with the duty of care owed to the target company, then he/she must compensate the target company and/or any third party for the damages suffered and thereby arising out of the breach. For PE investors, if there is a conflict of interest between themselves and the target company, then there may be a risk that the director of the target company appointed by them will execute actions that do not match their own interests.

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?

A PE investor appointed as a director also owes a duty of care to the target company, and, under the Companies Act, if such director wishes to engage in a conflict-of-interest transaction with the target company, then the approval of the board of directors is required. In addition, if a director has a special interest in a particular resolution, then he/she is not allowed under the Companies Act to participate in the approval of such resolution to ensure the fairness thereof. In addition, as mentioned in question 2.1 above, Investment LPS are often used in PE investments in Japan, and conflicts of interest may arise between the general partners and the limited partners even within a partnership. To prepare for such cases, it is often practice to set up an optional advisory committee in the partnership agreement to give consent on the actions of the general partners.

4 Transaction Terms: General

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

Major regulations that need to be taken into account when investing include the following:

- the Financial Instruments and Exchange Act ("FIEA") if foreign investors wish to acquire a certain amount of shares of listed companies;
- the FEFTA, which requires foreign investors to make a prior notification if they acquire a certain amount of shares of target companies that are engaged in the Designated Business Sectors, as well as post-reporting for certain capital transactions; and
- antimonopoly laws in Japan provide merger filing regulations based on the number of shares acquired by buyers and the annual sales of buyers and targets.

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

Although the amount of investments in Japan is still not significant, investments in Asia by foreign funds have been increasing.

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?

Under the FIEA, if a PE investor wishes to purchase more than ⅓ of the shares in a public company, then it must do so by a tender offer. Accordingly, most public-to-private transactions are done by making a tender offer. A tender offeror must submit documents that sufficiently show the balance of its deposit in a bank, or the existence of the funds necessary for the tender offer. Thereafter, a squeeze-out process takes place, such as a merger, share exchange, consolidation of shares, etc.

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

Deal protections are not commonly used in public-to-private transactions. Under the Fair M&A Guidelines, if a conflict of interest exists, such as an MBO, then a deal protection that entirely prohibits the target company from communicating with any party offering a competitive deal will be considered excessive. However, a reasonable breakup fee is permissible.

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?

If a PE investor is on the buy-side, it is preferable to create a completion account after closing to adjust the consideration.

The longer the period of the price adjustment or compensation, the better it is for the buy-side. The sell-side, however, frowns upon price adjustments and compensation and strongly prefers to set a ceiling on any price adjustment or compensation amount. They also tend to want the compensation period to be as short as possible.

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

On the sell-side, in addition to the seller's own representations and warranties, the seller often makes representations and warranties regarding matters that affect the business operations of the target company, such as its shares, assets, and liabilities. One unique representation and warranty in Japan is the anti-social forces clause, in which parties represent and warrant that they are not anti-social forces and they do not have any relationship with anti-social forces, etc.

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 examples include a pre-closing covenant not to engage in any transaction or conduct that would materially affect the target company's business without the prior consent of the seller before the closing date. Also, indemnification for breach of the representations and warranties or the share purchase agreement is common. In addition, the seller's obligations after the closing may include non-competition for a certain period and a prohibition of soliciting employees 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?

Although the frequency of use of representations and warranties insurance in Japan is still low compared to European and US countries, the recent launch by Japanese insurance companies of such insurance for buyers and sellers for domestic projects is expected to increase its use in the future. The limits, exclusions, and costs thereof vary depending on the insurance policy. For example, insurance products for small deals are relatively inexpensive, with a minimum premium of 3 million yen.

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

In most cases, the seller wants to set a maximum amount of compensation, thus, in many cases, such maximum amount is set. In addition, there are often restrictions on the period of compensation. The period varies from case to case, but it can be as long as one year to several years, or as short as a few months to six months.

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 Japan, the seller rarely guarantees debts in general PE investment transactions by transferring shares, and there are not many examples of the use of escrow accounts. One possible case of a guarantee by a PE seller would be when the PE buyer acquires the target company through a business transfer. For example, when the target company plans to liquidate after the closing and indemnification by the target company is not adequate after such closing. If the buyer also discovers a causal act during the due diligence process for which it would like to seek a guarantee or security for a debt, it is more common for the acquisition price to be reduced instead or for the seller to be compensated by a provision for special indemnification, which has a different period or maximum amount than the general indemnification obligation.

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 buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

To guarantee the buyer's general solvency, the buyer's representations and warranties may include that the buyer can pay the acquisition price. In addition, if the buyer is financing the acquisition by borrowing, then a prerequisite for the seller's execution of the transaction may include, among others, the buyer's submission of a copy of a commitment letter issued to the buyer by the financial institution.

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 fee" clauses are not common in Japan.

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?

First of all, a portfolio company must meet the requirements of the relevant securities exchange. Next, since it takes time to complete an IPO, it will be subject to volatile market conditions. Also, it is very costly to complete an IPO. Costs include the fees of a lead managing underwriter and an audit company to conduct a due diligence and give advice. The company must also, among others, adopt appropriate corporate governance structures, amend its articles of incorporation (e.g., abolishing the section on the transfer of shares and establishing the necessary bodies), submit securities registration statements with the authorities, and distribute the prospectus.

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

The rules of the Tokyo Stock Exchange, Inc. provide for an institutional lock-up whereby PE sellers who have received allotments of shares after one year prior to the end of the most recent fiscal year must continue to hold the shares until six months have passed from the listing day, or until one year has passed from the payment date or the end date of the payment period for the allotted shares if one year has not yet passed from such date.

In addition, there is a voluntary lock-up whereby PE sellers must usually hold the shares for 90 days or 180 days from the listing day per the agreement with the lead managing underwriter. In some cases, however, under such agreement, PE sellers may sell the shares even during such period if the price thereof equals or exceeds 1.5× the opening price.

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 Japan.

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 funds use debt finance to have leverage. To manage the leverage risk, the amount of the loan may be a certain percentage of the amount contributed or the amount committed to be contributed by the partners under the fund agreement. Leverage is regulated for venture capital funds that can offer their interests to a broader set of qualified institutional investors, including other funds. Such venture capital funds may generally not borrow money subject to certain exceptions under the FIEA and its relevant regulations. The most common sources of debt finance are senior loans by banks and other financial institutions, and mezzanine finance. Few high-yield bonds are issued in Japan because of the regulations mentioned in question 8.2 below.

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 in question 8.1 above, venture capital funds are not allowed to borrow money. Moreover, except for banks, insurance companies, etc., any person who intends to engage in the money lending business must meet the requirements and be registered under the Money Lending Business Act (Act No. 32 of 1983). Japanese securities firms are also regulated in dealing in corporate bonds lower than the investment grade of BBB under the Rules Concerning Dealing, etc., of Private Placement, etc., and of Corporate Bonds of the Japan Securities Dealers Association.

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

There have been no new trends in the debt financing market in Japan. The COVID-19 pandemic has not affected the market because of the public financial assistance extended by government-affiliated financial institutions and credit guarantee associations.

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 consideration in Japan is avoiding double taxation, which means taxation on both the funds as well as the investors. Thus, an Investment LPS, which is a partnership formed among general partner(s) and limited partner(s) pursuant to a limited partnership agreement for investment under the ILPA, is often used as a pass-through entity. However, an Investment LPS may not invest more than 50/100 of the total capital contribution of all the partners in shares, etc., of foreign corporations or other entities. Instead, a limited partnership ("LPS") formed under the Cayman Islands, the Virgin Islands, Ireland, the State of Delaware, or another country is used for funds that aim to invest in such shares.

Please note that the Supreme Court ruled in 2015 that a Delaware LPS was deemed a corporation under Japanese tax law. Thereafter, however, the National Tax Agency ("NTA") said though that "the NTA will no longer pursue any challenge to the fiscally transparent entity (FTE) treatment of an item derived through a U.S. LP". Moreover, the Supreme Court rejected an appeal from a high court judgment that ruled that an LPS formed under the laws of the Bermuda Islands was not deemed a corporation under Japanese tax law. An LPS formed under the laws of the Cayman Islands has also been deemed a pass-through entity.

In addition, if a foreign investor is deemed to have a permanent establishment in Japan, then it must file a tax return in Japan, and the fund must withhold tax from the distribution to such foreign investor. With certain exceptions, as mentioned in question 9.4 below, if even one partner has a permanent establishment in Japan, then all of the partners will be deemed to have a permanent establishment in Japan. Therefore, off-shore structures, which exclude residents and non-residents with a permanent establishment in Japan, are usually used for foreign investors.

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-qualified stock options, as mentioned below, are commonly used in private companies. For an ordinary or non-tax qualified stock option, a salary income tax of up to about 55% is imposed on the difference between the market price at the time of exercise and the price paid when it is exercised, and a capital gains tax of about 20% is imposed on the difference between the sale price and the market price at the time of exercise when the stock is sold. On the other hand, for tax-qualified stock options to be issued to directors, officers and employees of the company and its subsidiaries with certain exceptions and certain approved outside service providers subject to other certain requirements, no tax is imposed when they are exercised, and a capital gains tax of about 20% is imposed on the difference between the price paid and the sale price when the stock is sold.

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 are recognised and tax is imposed when the shares are transferred or exchanged for another set of shares, except for tax-qualified transactions including mergers, company splits, share exchanges and share transfers.

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 revision of the tax law in 2009, if a foreign investor (i) is a limited partner of the LPS, (ii) does not manage the LPS, (iii) owns an equity interest in the LPS less than 25% of the partnership assets of the LPS, (iv) does not have any of the certain types of relationship with a general partner of the LPS, (v) does not have any other permanent establishment in Japan, and (vi) submits a certain form, then such foreign investor will be deemed not to have a permanent establishment in Japan.

If a non-resident without a permanent establishment sells 5% or more of its shares in a Japanese company of which it owned 25% or more within the three-year period prior to the end of the fiscal year, then tax shall be imposed on the capital gains earned in Japan. Before the 2009 tax law revision, the above 5% and 25% thresholds were calculated per fund invested in by such foreign investor. However, after such tax law revision, such thresholds would now be calculated per foreign investor investing in fund(s), regardless of the percentages of the shares owned by such fund(s) in the Japanese company, if such foreign investor meets the requirements mentioned 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?

The recent amendment of the FEFTA expanded the range of businesses required prior notification. If foreign investors acquire a certain amount of shares (1% or more of the voting rights in listed companies, or one or more shares in unlisted companies) of a company engaged in a Designated Business Sector, including cybersecurity, infrastructure (oil, gas, electricity and water supply), etc., then they must make a prior notification. In addition, foreign investors must make a prior notification to conduct specific actions, such as giving consent at a general shareholders' meeting to appoint a foreign investor or "closely related person" as a director. However, the FEFTA now also provides a new prior notification exemption scheme for stock purchases if foreign investors can meet the specific criteria thereunder, such as if the foreign investor or closely related person does not become an officer of the investee company after the investment.

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

The amendment to the FEFTA mentioned in question 10.1 above imposes certain restrictions on foreign investors' investments in particular business sectors in Japan for national security reasons. PE investors' investments in such businesses shall also be subject to FEFTA 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.)?

Outside counsel often conducts legal due diligence, but the timeframe, importance, and scope of the due diligence vary depending on the size of the deal and the type of investment. Therefore, it is difficult to determine, among others, a typical timeframe. Nevertheless, in general terms, the scope of the due diligence often covers not only the validity of the shares to be acquired by the buyer but also the organisational profile of the target company and its assets (including IP), transaction agreements, permits and licences, compliance, and disputes.

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 Japan, bribery of public officials is punishable under the Criminal Code and, in a general legal due diligence, one of the matters that should be investigated is whether the target company has any material violation of laws and regulations. In addition, it is often a matter of representation and warranty by the seller that the investee company is free from any such material violation of laws. The transaction agreement may also provide the buyer's right to terminate the transaction if any such material violation is discovered before the closing date.

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 to item (i) above, when a PE fund invests in a stock company or a limited liability company, or even when it invests in a partnership as a limited liability partner (many investors invest as limited liability partners), it is not liable for the liabilities of the investee company unless there is an exceptional circumstance wherein the independence of the legal personality of the investor shareholder from the investee company is disregarded due to, for example, the legal principle of denial of legal personality. With respect to item (ii) above, the investee company is not liable for the debts of another investee company unless the former guarantees the debts of the latter to its 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?

Although the range of businesses that require prior notification for foreign investments has expanded, for national security reasons mentioned in section 10 above, the Japanese market is generally very open to foreign investments. Japan also revised the tax law to barely tax foreign investments in private equities through funds, as mentioned in question 9.4 above.

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Oh-Ebashi LPC & Partners ("Oh-Ebashi") is a full-service law firm with over 150 attorneys, and with its main offices in Tokyo and Osaka. It was originally established in Osaka in 1981 and now has an equivalent-sized operation in Tokyo. Oh-Ebashi was the first Japanese law firm to open an office in China. Together with its Nagoya Office, Oh-Ebashi currently has offices in four locations. Oh-Ebashi has been providing its clients with the best legal advice and solutions for decades and is committed to consistently exceeding the clients' expectations and being their ideal legal partner.
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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?

Domestic market activity in Jersey is driven by private equity ("PE") involvement in financial services sector business acquisitions and divestments. This includes transactions involving professional corporate services and trust company businesses, which are the focus of primary and secondary stage investments and market consolidation, by way of follow-on investment activity. Global banking businesses operating with a local presence in Jersey provide non-core business carve-out opportunities for PE sponsors in the local financial services sector.

Separately, a sustained use of Jersey vehicles by leading PE sponsors investing in larger scale primary cross-border deals, including exits by way of initial public offering ("IPO") or public to private ("P2P") acquisitions of quoted companies, has, in recent times, also gained traction.

In using Jersey in more globally focused cross-border transactions throughout 2020, the most significant sector growth has been in the infrastructure space and, in particular, in the following asset sub-classes:

- biotech;
- broadband internet service provision;
- refuse and recycling;
- midstream oil and gas ("O&G"); and
- transport and motorway services.

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

After a sustained period of competitive auctions and pre-emptive bids in the PE equity space, activity at the start of 2020 was heavily focused on complex carve-outs and identifying value in listed target companies with depressed share prices. Steady PE deal-making during the first quarter gave way to the challenges posed by the COVID-19 pandemic.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

While the long-term effects for PE of the COVID-19 pandemic in Jersey are difficult to predict with certainty, in the medium-term, appetite for secondary or tertiary stage investment in Jersey corporate and fund administration business has experienced a resurgence. Consistency of corporate client usage and annuity income streams rank among the most attractive features of these types of businesses. COVID-19-induced volatility has improved the attractiveness of P2P opportunities open to PE sponsors. Government intervention in the domestic economy has not impacted PE activity.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

A dramatic build-up in the reported cash balances of US and UK corporate groups has been so significant that such groups are increasingly seen as serious rivals to PE sponsors in targeting undervalued quoted and unquoted businesses. The appetite and buying power of larger businesses in the consumer retail space is noticeable. Some of the main points of difference in deal terms include the basis upon which trade buyers want to go out for warranty and indemnity ("W&I") insurance, the mix of non-cash consideration on offer where the trade buyer forms part of a large listed group and longer lock-in periods for management executives.

2 Structuring Matters

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

Most PE acquisitions in Jersey are structured as private treaty sales with purchase agreements negotiated between the parties. Competitive auction processes are common in the infrastructure space, where prime assets are coveted. Larger transactions involving a Jersey target company or listed targets may proceed by way of a court-sanctioned scheme of arrangement or Takeover Code-governed process (see below). Other acquisition types include statutory mergers and business asset transfers, although these are less frequently encountered.

2.2 What are the main drivers for these acquisition structures?

Most PE deals in Jersey, or those involving Jersey PE acquisition structures, target majority PE fund ownership. Co-investment structures are an increasingly popular way to syndicate the equity contribution to be made. However, it is not uncommon to see primary investment opportunities initially involve PE sponsors acquiring minority interests in target groups pending enterprise valuation adjustments and similar. Acquisitions effected by Jersey court-sanctioned scheme of arrangement have been less frequent in the last 12 to 24 months.

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

PE sponsors use small proportions of equity finance to subscribe for ordinary or preferred ordinary shares in the ultimate acquisition holding or top company. The balance is generally invested as shareholder loans (often structured as payment-in-kind or PIK loan notes), preference shares or hybrid instruments. These instruments represent the institutional strip. Management will generally subscribe for ordinary shares in Topco representing between 10% and 20%, and this interest by management is known as 'sweet equity'. In some PE buyout processes, key senior management who may be rolling over interests invested in a primary transaction may also be invited (or required) to invest in the institutional strip.

Carried interest (which represents a share of the PE fund's overall profits) is typically structured through a limited partnership, with executives or their private investment companies or trusts (or "PICs") as limited partners. Frequently, the carried interest limited partnership is a special limited partner in the investing PE fund. Carried interest or the 'carry' is generally calculated on a whole-of-fund basis after investors have received a return of their drawn-down capital, plus any preferred return accrued and after any agreed hurdles are cleared.

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

Co-investment among sponsors is more of a US PE-driven concept that has started to increase in popularity where US or global PE sponsors are looking to put together 'club' acquisitions of UK and European assets. Broadly speaking, the structuring considerations are the same where a PE sponsor is taking a minority interest in a portfolio company acquisition relative to the size of the minority interest being taken.

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?

Unsurprisingly, incentivisation of management teams is a key feature of PE transactions in Jersey and those that involve Jersey vehicles. Different drivers and expectations from both PE sponsors and the management team come into focus where the market is moving to a more 'patient capital' model, compared to shorter hold periods typically associated with PE in a seller-friendly landscape. Up to 10% of equity participation by management is common, but certain and more entrepreneurial management teams have been able to command a higher proportionate equity ownership share (20%).

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

If managers leave the portfolio business before a certain date, they will normally forfeit their sweet equity. Good and bad leaver provisions are typical, with preferential terms applying to individuals who leave for 'good' reasons. Generally, this includes managers who leave due to illness, death, disability and retirement. Four or five years are typical vesting periods or, otherwise, an exit is the most common. Full vesting on an exit event that takes place earlier than anticipated generally means that everyone benefits.

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?

Entry into an investment or shareholders' agreement that regulates the rights and obligations of the PE acquisition transaction counterparties (i.e. the PE sponsor, portfolio company and management) is the most common form of governance arrangement for PE portfolio companies. Such agreements often include provisions regulating matters such as: (a) restrictive covenants on management with regard to the conduct of the business of the portfolio company; (b) extensive veto rights for the PE sponsor; and (c) restrictions on the transfer of securities in the portfolio company.

Similar to the position under English law, in Jersey, there is no general obligation to file (and make publicly available) a shareholders' agreement. Where a shareholders' agreement entered into by all members of a Jersey company constitutes a special resolution amending a company's articles (or would not be effective for its purpose if not passed as a special resolution), the shareholders' agreement would be required to be filed. However, it is highly unlikely that a shareholders' agreement would be subject to such a filing requirement in Jersey because of the way in which such agreements, and their interaction with a company's articles of association, are structured. The constitutive documents of acquisition structure companies (articles of association, etc.) will also contain certain 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?

Where PE sponsors hold a majority ownership position in a portfolio company asset, they normally enjoy significant veto rights over major corporate, commercial and financial matters pertaining to the portfolio company business, although thresholds are commonly set to ensure that day-to-day decisions can be taken by management.

The extensive veto rights in favour of PE sponsors will typically be split between director veto rights and shareholder veto rights. Such veto rights (or reserved matters) would include amendments to the capital structure, constitutional documents, entering into, amending or terminating material contracts, changing the nature of the business or entering into new business lines, and commencing or settling litigation.

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 Jersey, veto rights will constitute the legal, valid and binding obligations of the parties submitting to them, provided they do not constitute a fetter on the Jersey company's statutory powers.

At shareholder level, the investment or shareholders' agreement will address particular veto arrangements and may include procurement obligations to ensure veto powers are given proper effect to. Director nominee level veto rights can be enshrined in the relevant Jersey company's articles of association absent public disclosure sensitivity.

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?

Management shareholders in PE transactions are not afforded greater or different rights than minority shareholders in other situations under Jersey company law. The standard legal protections that exist include claims in relation to minority oppression and unfair prejudice, etc.

It is usual for contractual pre-emption rights in favour of management to exist in relation to sweet equity. Such rights are intended to offer some kind of anti-dilution protection to management. However, if significant additional equity funding is obtained or if a larger number of new or existing management are offered and take up sweet equity, limited pre-emption may not fully or effectively operate as anti-dilution protection.

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 where a shareholders' agreement fetters the ability of a Jersey company to exercise statutory rights or powers or the subject matter of the agreement offends public policy in some manner, a Jersey court would (if required) uphold the legal validity and enforceability of a shareholders' agreement. Typically, where Jersey companies are involved in cross-border downstream PE transactions, the governing law of the shareholder agreement will not be Jersey law and is more likely to be English law or New York law. Non-compete and non-solicit provisions should follow the local law position where the portfolio company business operates to ensure validity. This is rarely Jersey 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?

The usual range of company law restrictions in relation to director eligibility apply to PE transactions in which PE sponsors appoint nominees to boards of portfolio companies. PE sponsors should be aware of corporate governance and tax residency-related concerns in appointing nominee directors. For example, where a Jersey PE acquisition holding company is required to be tax resident in the UK, it would be usual for the board to comprise UK resident individuals.

In terms of risks and potential liabilities for PE investors in appointing a nominee director, in Jersey, a director is defined as a person occupying the position of director by whatever name they are called. This results in a more than theoretical risk that if the PE investor appointor, in exercising its director nominee appointments, acts in such a way so as to exert control or quasi-control of the relevant Jersey company, then the investor may face exposure to liability for acting as a *de facto* or shadow director. The impact of this is that all the attendant Jersey law duties, responsibilities and liabilities of being a director would apply to the PE investor appointor.

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?

Jersey company law operates on a permissive basis in relation to director conflicts of interest on the basis of disclosure. A director must disclose any direct or indirect interest they have in any transaction entered into by the company that materially conflicts with the company's interests. Positions held by nominated directors on a range of portfolio company boards can similarly be addressed and sanctioned via a series of appropriate disclosures. Directors owe duties to the company and not their appointors.

4 Transaction Terms: General

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

Apart from the timing issues associated with competitive auction processes, pre-empts and deal execution, the external issues impacting timing for transactions are largely affected by application for regulatory authorisations such as anti-trust/competition, financial services, regulatory, change of control and various other sector-specific consents. While there is no foreign direct investment regime that is applicable in Jersey, there are a number of other real estate-related, fundraising and domestic approvals that may be needed to acquire a Jersey target business.

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

Depressed valuations, the confluence of post-Brexit trading conditions and the impact of the COVID-19 pandemic mean that conditions continue to favour PE sponsors. Trends that play to the advantage of PE sponsors include:

- relatively light touch legal/other due diligence being run on acquisition transactions;
- minimising deal execution risk by limiting termination rights;
- the 'outsourcing' of warranty coverage to W&I insurers; and
- involvement of PE sponsors as alternate credit providers.

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 UK City Code on Takeovers and Mergers ("Takeover Code") applies to certain transactions involving Jersey companies. Takeover Code compliance is implemented by the UK Takeover Panel, as the designated authority under primary Jersey legislation.

A Jersey company is subject to the Takeover Code if any of its securities are listed on a regulated market or multilateral trading facility in the UK or on any stock exchange in the Channel Islands or the Isle of Man. This includes being listed on the main board of the London Stock Exchange ("LSE") and on the Alternative Investment Market. A Jersey company that has shares listed on other exchanges, such as NYSE and NASDAQ, may also be subject to the Takeover Code if the Panel considers that the company's management and control is in either the UK, the Channel Islands or the Isle of Man.

The certainty of funds cash confirmations required to be given by purchasers to sellers of a target business has become a staple feature of a P2P transaction and often results in first interim and then senior credit arrangements to be put in place.

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

Deal protection measures like break fees have not featured in Jersey transactions involving PE-backed buyers. In larger cross-border transactions with a Jersey element, break fees were more common prior to their abolition, as a result of changes to the Takeover Code in September 2011.

Reverse break fees are not customary in Jersey transactions involving PE-backed buyers. However, as they are not prohibited by the Takeover Code, they are permissible, subject to Jersey law rules on excessive penalties, which are, broadly speaking, similar to those that apply under English common law.

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?

There is generally no restriction on the type of consideration that can be offered on a private treaty sale or negotiated offer. Consideration can therefore include, among other things, cash, loan notes and shares. In a Takeover Code-governed mandatory offer, the consideration must be cash, or be accompanied by a cash alternative, and comply with minimum consideration requirements.

There is no predominant form of consideration structure used in these types of transaction. Fixed-price, locked-box and completion accounts mechanisms are variously seen on Jersey PE transactions, with locked-box transactions typically being preferred by buy-side PE sponsors. Protection afforded by PE buyers and sellers in relation to the consideration mechanism is generally the same in terms of the protection provided by corporate buyers/sellers.

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

Warranty coverage in PE transactions in Jersey is generally limited to title of target shares or assets, capacity and authorisation to enter into the transaction, solvency and accuracy and completeness of information provided to the buyer. Warranties are usually limited in duration to a 12–24-month claim period. While most primary PE investment transactions in Jersey involve a management team standing behind the deal terms and providing certain limited warranties, other deal protection measures such as earn-outs and lock-ins provide more comfort to PE-backed buyers.

Full disclosure of the data room is typically allowed against the 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?

Indemnities from a PE seller and/or management team are not common in an MBO context. Earn-outs, lock-ins and price adjustment provisions are often negotiated as part of the management's specific terms of an acquisition agreement or rollover investment/shareholders' agreement. A tax covenant and deed of indemnity is also a relatively common feature and further allows the allocation of risk as between buyer and seller. Dollar-for-dollar recovery for unexpected tax liabilities arising as a result of pre-completion profits or events occurring prior to completion provides buyer protection.

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 W&I-insured deals are increasingly common following the trend in the UK and elsewhere. W&I coverage increases the relatively low level of protection that management teams are able to provide and PE sellers are not prepared to consider. The additional diligence and input from a seller on an insured deal is often accepted as necessary from a buyer's perspective. The cost of insuring known risks is generally prohibitive and, therefore, is less common.

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

In Jersey, market practice is a more powerful driver in respect of the allocation of risk between parties to a PE acquisition transaction than the type or nature of the parties involved. The extent to which PE sellers assume ongoing liability in a divestment is very limited. In buyer-insured transactions, nominally capping seller liability will result in only theoretical risk for PE sellers.

The main ways a PE seller will look to limit liability include negotiating:

- caps on financial exposure;
- time periods by which claims can be made (e.g. 12 to 24 months);
- *de minimis* claim levels (individual and aggregate);
- regulating the conduct of a dispute regarding a breach of warranty or any third-party claims; and
- obligations on buyers to mitigate loss suffered.

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 rare for a PE seller to provide any form of cash-backed or other security for warranties/liabilities. The risk of claim is considered low by buyers where PE sellers provide limited warranties (title, capacity and authority, etc.). Also, a focus on a short period of time post-completion for any no-leakage/true-up payments, etc., means PE sellers are focused on returning exit proceeds to their investors as soon as possible post-completion.

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 buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Comfort is typically provided by the PE buyer to the seller in the form of a certain funds cash confirmation or debt/equity commitment confirmation once interim credit arrangements are put in place (as to which, see further below). Suing for damages for contractual breach is the primary right of enforcement that sellers typically obtain to protect against non-compliance by buyers.

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

See response to question 5.2.

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?

As most PE transactions in Jersey are of financial services sector/regulated businesses, auction sales to strategic trade buyers and other PE sponsors (in secondary or tertiary transactions) are all normal. In 2020, given the COVID-19-induced volatility in the capital markets and in relation to FX currency trading, IPOs have been the least attractive form of exit strategy. Dual-track (IPOs and private sale) processes running concurrently have, in the last eight years in Jersey, become more common. However, it is interesting to note that during this time, only three Jersey PE-owned portfolio companies have conducted successful IPOs, implying that a higher rate of success has been achieved with private sale processes. Reinvestment by PE sponsors (save for an IPO exit scenario) is not typical. Please also see our response to question 11.1.

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

In a successful IPO exit, a PE sponsor (as selling shareholder) will be 'locked up' for up to six months with management locked up for a somewhat longer time, e.g. 12–18 months. Relationship agreements covering lock-up and other management and transitional matters are generally entered into between the PE sponsor seller and the listed company.

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?

See the responses to questions 7.1 and 11.1.

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, PE transactions are financed via a mix of equity contributions sourced from investing PE funds and external debt/leverage provided by syndicate banks, institutional financiers and a range of alternate credit providers. For larger transactions, accessing funding from the debt capital markets, i.e. bridge to high-yield bond financing, is attractive from a cost of funds perspective. Unitranche financing, which involves a hybrid loan structure, combining senior and subordinated debt into one loan facility at a blended interest rate, has also proved attractive to PE sponsors.

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, there are no relevant legal requirements or restrictions that would impact the nature or structure of the credit arrangements to be entered into by a PE sponsor buyer or the type of debt financing obtained. Practical deal terms are significant in dictating the ultimate financing structure.

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

See the response to question 8.1.

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?

The operation of a tax-neutral environment in Jersey for international businesses that feature Jersey corporate holding structures means that there are limited Jersey tax considerations for buyers or sellers structuring a cross-border transaction. Where the target is a Jersey corporate services and fund administration business, the main consideration will be the income tax that business is liable to account for as a Financial Services Company for Jersey income tax purposes. However, Jersey not levying any stamp duty or transactional imports like capital gains tax again means that tax does not feature prominently in the structuring of a local acquisition transaction.

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 use of Jersey PE acquisition holding structures generally provides UK resident non-UK domiciled target management with remittance-based taxation options for future exit. This can be achieved by the issuance of and subscription for management loan notes, which may require listing on an HMRC-recognised stock exchange if such loan arrangements are to qualify for certain UK withholding tax exemptions.

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 rollover-associated Jersey tax considerations for Jersey target management teams to consider.

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?

Jersey implemented The Taxation (Companies – Economic Substance) (Jersey) Law 2019 ("ES Law"), which came into force with effect from 1 January 2019.

The ES Law applies to a company incorporated or tax resident in Jersey, which generates income from a 'relevant activity', including, among other activities, fund management business, holding company business or financing and leasing business.

As Jersey tax resident companies in PE acquisition structures are generally fully administered and managed companies, certain activities conducted by the Jersey administrator in Jersey will assist the company to meet the economic substance test under the ES Law with limited additional impact or burden.

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?

PE sponsors that are focused on turnaround style assets are likely to benefit from a recent change in the Jersey prospectus rules, which have the effect of sponsors not needing to seek a prospectus consent in Jersey for certain types of acquisition transactions that involve debt-for-equity swaps with listed note or bond holders. In summary, certain Jersey private companies will not now come within the definition of issuing a prospectus, which means they will not be supervised by the Takeover Panel in its administration of the Takeover Code.

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

Mainstream PE investors will not be subject to enhanced regulatory scrutiny in Jersey on the basis of national security grounds. The Jersey Financial Services Commission ("JFSC") does maintain a sound business practice policy that identifies certain types of industry sectors and activities in relation to which the JFSC is interested in closely scrutinising counterparties or transactions that are connected to national defence/security activities or operations.

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.)?

While PE investors typically conduct relatively detailed legal due diligence, a noticeable recent trend is that legal due diligence completed by PE investors prior to committing to acquisitions has reduced in scope and coverage. Confirmatory legal due diligence is acceptable in a wide variety of mid-market PE transactions.

Vendor due diligence ("VDD") reports featuring as part of PE transactions depend almost entirely upon the shape of the target group structure and the underlying asset class. VDD is often not comprehensive and, in Jersey, is not generally considered a substitute for a buyer's own due diligence. A VDD report may provide a helpful start to the due diligence process. An obvious advantage is where a vendor is prepared to make representations and warranties, or provide indemnities, in the transaction documents in relation to information contained in the VDD 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.)?

Relevant ABC sanctions, anti-money laundering and Know Your Customer rules apply to PE transactions in Jersey. There are no PE specific restrictions.

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 both of these contexts, Jersey company law contains the concepts of separate legal personality and limited liability. It recognises that the legal personality of a company is separate to that of its shareholders. Limited liability is the principle that protects shareholders from claims over assets other than those legally owned by a company. In practice, in the context of a private limited Jersey company, this principle operates to effectively limit the liability of PE investors and 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?

One of the most interesting developments (not necessarily a concern) for PE investors in Jersey is the advent of European SPACs, which are expected to come to market in Autumn 2021. A SPAC is a type of company formed to raise money from investors, which it then uses to acquire another operating business.

The number of potential PE private investors in public equity ("PIPE") looking to invest via SPACs is significant. The LSE is well positioned to establish itself as a market of choice for PIPE investors focused on investing in European SPACs.

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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?

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 regulated side, recent years have seen an increasing use of the RAIF.

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 was 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 currently 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. Due to recent substance requirements, more private equity firm offices are growing in Luxembourg. 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. However, the current COVID-19 pandemic is the most significant factor affecting private equity transactions. All industries across the world have been affected by the economic consequences of the COVID-19 pandemic and private equity is not an exception to this; it is inhibiting a number of private equity transactions in Luxembourg.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

At this stage in the COVID-19 pandemic, it is difficult to ascertain what the future impact will be on private equity in Luxembourg. However, from the stage we are already at, there are a number of possible long-term effects resulting from COVID-19. The pandemic has created an ongoing uncertainty, which additionally presents the possibility of strategic opportunity to those firms that have cash available.

Private equity deals are still moving, albeit at a marked slower pace. Those deals that were due to close within the lockdown period are now closing, as well as those in the latter part of negotiations, continuing to be signed. However, deals in the earlier stages of negotiations appear to be slowing down, with some being put off until the market begins to stabilise.

While the above is the case for a number of private equity firms, there are a number of other private equity firms with significant levels of cash in hand and so are viewing the current climate as a good opportunity to invest. As we have seen acquisition prices steadily increasing over recent years, this has enabled a number of firms to accumulate significant sums of cash. Because of this, the industry could see a number of transactions by such firms with cash in hand. This is particularly likely to be seen in industries such as travel and entertainment, as they have been hit hardest by the COVID-19 pandemic. Such transactions are likely to be of those where companies are strapped for cash, rather than a takeover.

To summarise, caution is certainly still the order in Luxembourg. In a survey conducted by the Luxembourg Private Equity Association (LPEA) amongst Luxembourg-based GPs and LPs in July 2020, on the back of improved visibility, the impact of COVID-19 has not worsened for 85% of respondents when compared with March 2020. However, respondents recognised that the most-hit area is new business and expect the NAV to land between -5% and -25% at the year's end.

The Luxembourg government put in place several measures to support investments in Luxembourg, such as the investment aid aimed at stimulating business investments in the COVID-19 period. The Luxembourg government is granting, under certain conditions, investment aid to encourage companies in financial difficulty, following a significant drop in turnover, to carry our investments that would have been cancelled or postponed as a result of the economic crisis cause by the COVID-19 pandemic. The aid application, deemed complete, must be sent to the Ministry of Economy before 1 November 2021.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

On the regulated side, there is a tendency for the pension funds and insurance companies to become more active in the Luxembourg PE market; however, the most remarkable recent development in that respect is the increasingly frequent involvement of family offices. Pursuant to a recent survey conducted by the LPEA amongst Luxembourg family offices, on average, 35% of the assets in portfolios managed by Luxembourg family offices were alternative investments and 73% of those investing in this asset class expect private investments to deliver higher returns than public investments. Further, also in light of the recent COVID-19 crisis, family offices appreciate the greater control and visibility offered by private equity compared with public investments.

In that sense, deal terms are likely to be no different from those required by a traditional private equity firm taking a minority stake. Differences exist, however, e.g. financing contingency clauses are rarely required by a family office investor and there is less appetite in getting involved on the operational level. Family offices often also have a longer investment horizon and exit plans may be less prescriptive than for a traditional private equity firm.

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 that in turn acquire and hold the target shares or assets. In secondary buy-out situations, the original acquisition structure is typically 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 that 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" types 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 that in turn acquire and hold the target shares or assets. In secondary buy-out situations, the original acquisition structure is typically 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" types 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 the 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 shareholders' 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 that 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 and not in that of the 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)?

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 are, 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 that 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, foreign direct investment and other regulatory approval requirements, disclosure obligations and financing issues?

Traditionally, 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.

However, in line with recent trends in other European jurisdictions, a bill of law (No. 7578) aiming to regulate foreign direct investments (the Bill) was introduced into the legislation process on 11 June 2020. The Bill is still under review by the various stakeholders and, therefore, subject to change; however, the current status suggests that a mandatory procedure of prior notification to, and authorisation by, the Ministry of Economy will be implemented for certain foreign investments. The Ministry will be able to scrutinise and evaluate proposed foreign investment in order to determine whether a foreign investment is likely to affect public security and public order or essential national or European interests. According to the current draft of the Bill, the Ministry will be able to impose conditions or prohibit a proposed transaction altogether if public security and public order or essential national or European interests are affected.

It is expected that the potential effects on the following elements will be particularly decisive for the Ministry's assessment:

(a) critical infrastructure, whether physical or virtual, including infrastructure relating to energy, transport, water, health, communications, media, data processing or storage, aerospace, defence, electoral or financial infrastructure and sensitive facilities, as well as land and real estate essential for the use of such infrastructure;

(b) critical technologies and dual-use items within the meaning of Article 2(1) of Council Regulation (EC) No. 428/2009 of 5 May 2009;

(c) the supply of essential inputs, including energy or raw materials, and food or health safety;

(d) access to or the ability to control sensitive information, including personal data; and

(e) freedom and pluralism of the media.

While still in early stages, it can be expected that the foreign investment regime, once implemented, will be in line with the recent trend of renewed protectionism seen in neighbouring countries such as France and Germany.

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.

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 are less frequent than in other jurisdictions.

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the 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 (W&I) 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, although 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 buyer (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 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 that 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 a 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 a 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 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.

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.

Finally, Directive (EU) 2018/822 (DAC 6) has been implemented into Luxembourg domestic law by the law of 25 March 2020 (the DAC 6 Law). In response to the impact of the COVID-19 pandemic, on 18 June 2020, the Luxembourg tax administration announced that the reporting obligation for cross-border structures will take effect on 1 January 2021 instead of 1 July 2020.

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 80 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 (ranked 9 out of 198). 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.

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 those indicated specifically in this chapter.

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Eversheds Sutherland is one of the largest full-service law firms in the world, acting for the public and private sectors. We have thousands of people working worldwide and 69 offices in 34 jurisdictions across Europe, the United States, the Middle East, Africa and Asia. Our Luxembourg office focuses on corporate clients and investment funds. We advise domestic and international clients (including large corporates, private equity houses and fund managers) on private equity transactions and M&A as well as the structuring, setting-up and organisation of all types of AIFs, UCITS funds and corporate entities. We also advise on regulatory issues relating to investment funds and portfolio managers.

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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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?

The most common types of private equity (PE) transactions in Nigeria are share acquisitions (effected via subscription or transfer), quasi-equity instruments, and debt.

The market remains relatively resilient despite the impact of the pandemic and macroeconomic factors including the decline in global oil prices. PE and venture capital (VC) deal activity has increased in sectors such as: healthcare and life sciences, including biotechnology (notable deals involved genomics start-up 54Gene and in healthcare technology solutions provider, Helium Health); technology, including financial technology and payment processing (historic investments included Flutterwave's US$170 million Series-C funding led by Tiger Global and Avenir Growth Capital and Stripe's US$200 million acquisition of PayStack); and agribusiness, due to emerging opportunities from and following the pandemic, with investor appetite sustained in financial services and fast-moving consumer goods.

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

In addition to the impact of the COVID-19 pandemic, population size, consumer demographics, a cheap and relatively educated labour force, sectoral restructuring, the ongoing dynamic expansion of the Nigerian technology ecosystems yielding digital dividends across sectors like payment processing, e-commerce, agribusiness, technology infrastructure and more, together with evolving policies, help boost PE activity, in addition to some economic recovery following the rebound in oil prices.

Continuing fundraising slowed down during the pandemic and there has also been a discernible increase in VC investments. Ongoing development financial institutions' (DFIs) participation continues to support investments. Other than occasional foreign exchange (FX) availability challenges, the repatriation of proceeds from investments in Nigeria remains relatively straightforward.

Pandemic restrictions, valuation, regulatory challenges, currency depreciation, FX availability, infrastructure deficit and local content requirements and other factors, continue to impact transactional activity. Limited Partners (LPs) and General Partners (GPs), however, predict a positive outlook for investment in the next three years.

The new Companies and Allied Matters Act 2020 (CAMA) streamlines and strengthens the legal, regulatory, and administrative framework and boosts the ease of doing-business policies for micro, small and medium enterprises (MSMEs) in Nigeria, addressing bottlenecks that had hitherto impeded investment. Please see questions 9.3 and 9.4 for discussions on the implications of the Finance Act 2019.

While there was a decline in Nigerian petroleum sector investments in Q4 2020, the market outlook for investment activity is cautiously optimistic, with key player exits and the sale of significant sector assets. The Nigeria Extractive Industries Transparency Initiative had previously estimated losses of about US$200 billion as resulting from the decades-long delayed passage of the Petroleum Industry Bill. With the relative certainty and stability that will follow the passage of the statute by both Nigerian legislative houses, however, the scope for opportunistic exits and investments in the sector may increase, especially if the approved bill receives Presidential assent.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

The pandemic presented challenges for deal-making in Nigeria, for instance in relation to asset and target valuations, navigating existing agreements that were not structured to preserve target cash flow or business continuity or to address pandemic-specific *force majeure* events and material adverse change (MAC) triggers. The use of virtual data rooms and online conferencing facilities has increased to preserve due diligence feasibility and continuity and to help mitigate disruptions to deal timelines, particularly during lockdowns and travel restrictions. Negotiations of closing conditions, representations and warranties have become more robust in certain deals, with parties adopting innovative investment strategies, restructuring debt, and hedging investments to address FX fluctuations and economic uncertainty.

Nigerian intervention in the economy has included a national budget: (a) aimed at accelerating the pace of Nigeria's economic recovery, promoting economic diversification, enhancing competitiveness and ensuring social inclusion; (b) the technical devaluation of the Naira (NGN) from an official Central Bank of Nigeria (CBN) rate of NGN380.2 (USD1) to NGN410.05 (USD1); and (c) the enactment of new laws and regulations including the CAMA, the Banks and Other Financial Institutions Act 2020 (BOFIA), the Finance Act 2019 (which became effective in 2020) and the Finance Act 2020 (which became effective in 2021), as well as the Merger Review Regulations and Merger Review Guidelines issued by the Federal Competition and Consumer Protection Commission (FCCPC), which subject various transactional arrangements and agreements (including those relating to voting, governance and other reserved matters beyond equity ownership) to regulatory review to determine whether proposed investors will have material influence on targets. These developments impact on and have influenced PE activity, deal structuring and implementation.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

Sovereign wealth funds (SWFs), VCs, DFIs and high-net-worth individuals (HNIs) are executing PE-style cross-border transactions due to emerging opportunities created by the pandemic, healthcare deficits and technology. Key divergences in deal structuring and approach are the ability of some DFIs and HNIs to take long-term positions in certain sectors and targets, unlike PE investors who are typically restricted to a five- to seven-year investment period. Also notable are the apparent flexibility and speed of execution of cross-border SWF and VC investments.

2 Structuring Matters

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

Bilateral acquisitions of shares in Nigerian target companies remain the most common, often implemented by investor-controlled, offshore-registered special purpose vehicles (SPVs). Current economic challenges and risk management concerns, however, contribute to continuing trends of quasi-equity, convertible debt instruments and alternative capital structures. With respect to VC deals, Simple Agreements for Future Equity (SAFE agreements) are increasingly considered for very early-stage transactions due to their convenience and simplicity.

2.2 What are the main drivers for these acquisition structures?

The preservation of control is a key driver. Majority holdings often confer control, while minority holdings are more reliant on contractual rights and protections, including nominations of directors and executives to provide insight into financials and business operations. Other drivers include risk mitigation, flexibility, exit considerations, maximisation of returns and tax efficiency. Share transfers are exempt from capital gains tax (CGT).

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

A target's equity structure will usually reflect capital contributions. Shareholders and management typically participate through an investment company, with management interest being in the region of 5%, although this varies from deal to deal. Carried interest is typically structured through a separate vehicle, often an offshore limited partnership with equity in an offshore holding company (BuyCo) subject to agreed percentage splits.

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

Minority protections mechanisms may include voting and quorum arrangements, information and access rights, participation in key decisions, including entry into certain contracts, governance, board and board committee participation and nomination rights in relation to key executives and board members, including board chairpersons, all with the ultimate objective of attaining control and influence over key matters. Minority investors may require such strategies to be entrenched in transaction contracts as well as constitutional documents. Transactions in which investors require minority protections deemed to confer them with material influence over a target's policy under the Merger Review Regulations and Guidelines will be subject to the FCCPC's prior review and consent.

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 is typically 5%–10%. Transaction documents may include "good leaver" and "bad leaver" provisions that determine the compulsory acquisition of and pricing of 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 reason of retirement, death or disability) and "bad leavers" (e.g. management employees terminated for breaches such as fraud, other criminal or civil offences or specified instances of 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?

Governance arrangements typically confer control and protection 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. Shareholder agreements are generally confidential but may be replicated in target constitutional documents that must be publicly filed at the Corporate Affairs Commission (the CAC). While governance arrangements in private companies are not required to be publicly disclosed, information that could materially affect a listed target's share price (including shareholders' agreement signed by the target) may be required to be publicly disclosed. New merger control requirements relating to material influence may subject such arrangements to FCCPC approval.

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 CAMA prescribes minimum approval thresholds for specified decisions as ordinary resolutions (50%+1 vote) and special resolutions (75%), and for board decisions via a majority. Subject to such prescriptions, PE investors seek supermajorities and veto rights over key corporate actions typically designated as "reserved matters" requiring their participation or approval (such as acquisitions, restructurings, disposals, business plans, significant expenditures, related party transactions, debt arrangements, executive appointments, share capital changes, board composition, constitutional amendments, etc.) entrenched in the shareholders' agreement and in the target's articles of association.

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, including fixed voting thresholds for certain decisions, e.g. director removals, will override conflicting arrangements in shareholder agreements and constitutional documents, rendering them unenforceable. Directors have fiduciary obligations to the target and may not fetter their discretion to vote in any manner; however, nominating shareholders may have obligations to procure specified decision outcomes.

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 applicable laws including the CAMA, the Investment and Securities Act (ISA), and the Securities and Exchange Commission rules and regulations that protect minorities. Mandatory tender offers may be triggered by direct or indirect changes of control from acquisitions of more than 30% equity interest, or of more than 50% interest effected simultaneously or via a series of deals featuring parties acting in concert with the acquirer, subject to exemptions. The Nigerian Code of Corporate Governance 2018 (NCCG Code) requires that the board must ensure fair treatment of all shareholders and that minorities are protected from the overbearing influence of controlling 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)?

Shareholders' agreements are subject to mandatory provisions of applicable law. 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) that has "some 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 enforceable subject to the Federal Competition and Consumer Act (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?

Board nominees have fiduciary obligations and may not fetter their discretion to vote in any manner. The CAMA imposes qualifications and restrictions, including that directors must not be fraudulent, bankrupt, mentally unsound, or convicted by a High Court of any offence connected with the promotion, formation, or management of a company. The NCCG Code prohibits the simultaneous appointment of an individual as both chairman and managing director/CEO of any entity. Sectoral qualifications may apply; for instance, the CBN prescribes specific qualifications for bank directors. Regulatory approvals may be required, e.g. for appointments to the boards of banks and other financial institutions and insurance companies, among others.

Directors may incur personal liability, e.g. for loss or damage sustained by third parties from untrue statements or misstatements in a public company prospectus. An executive director's termination of employment will not result in his or her automatic removal from the board; involuntary removals of directors must follow a prescribed statutory process. The 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 and the NCCG Code prescribe that the personal interest of a director must not conflict with his or her duties as a director. A director may not, in the course of managing the affairs of a company, misuse corporate information to derive benefits, and must be accountable to the company for any benefit so derived, even after he or she resigns from the company. Sitting on the board of more than one company concurrently (discouraged under the NCCG Code to avoid conflicts of interest) does not excuse a director from fiduciary duties to both, including a duty not to (mis)use property, opportunity, or information. Actual and potential conflicts of interest are required to be disclosed to the target's board for consideration. Subject to this, nominee directors may recuse themselves from votes on conflicting board decisions. Where this may not suffice to resolve conflicts, it may be in the overall interest of portfolio companies if a conflicted director leaves the board.

4 Transaction Terms: General

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

Transactions can be completed quickly if they are not complex and involve compliant and organised targets (with complete, accessible records), experienced parties and advisers, and require no regulatory approvals. Delays may, however, arise during capital raising and due diligence (especially where records are not provided or tasks include external searches and verifications), in procuring regulatory authorisations or compliance including from the FCCPC and sector regulators prior to or following the transactions.

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

Parties are becoming increasingly creative in structuring equity, debt and alternative capital deal terms to diversify and mitigate risk exposure in response to foreign currency volatility, macroeconomic and other challenges. As these challenges become more apparent in the current global pandemic, it is expected that the trends in key contractual provisions referenced above will continue to evolve. While PE investors continue to structure cross-border transactions to provide flexibility from a governance and fiscal perspective, deferred consideration and escrow structures geared towards protecting investments from the negative impacts of the pandemic or target red flags are not uncommon, nor are cancellation and early termination mechanisms, which are also rigorously negotiated. Whether the emergence of various COVID-19-specific financial measures, e.g. "EBITDAC" (where the "C" stands for coronavirus), will evolve into a multi-year trend remains to be seen.

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 Code of Corporate Governance for Public Companies in Nigeria 2011 regulate 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. FCCPC approval and sector-specific reporting obligations may apply. PE investors and targets typically retain experienced professional advisers to ensure compliance.

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

Deal protection mechanisms include structures that isolate identified liabilities following due diligence, representations and warranties, indemnities, insurance, escrow arrangements, deferred consideration, early cancellation, etc. as indicated above, break fees, "no-shop", exclusivity, lock-ups and voting arrangements.

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 by both buy- and sell-side investors. Share swaps and structures incorporating earn-out arrangements appear to be increasingly considered following the pandemic onset.

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

This is subject to negotiation. Exiting PE sellers will typically seek to give warranties, e.g. limited to title, capacity, business, pre-closing tax liabilities, etc., and short limitation of liability obligations and periods ranging from six months to two years for non-tax liabilities. Sellers may seek to include anti-sandbagging provisions, materiality and buyers' knowledge qualifiers. Where investors and founder(s) exit simultaneously, buyers may seek comprehensive warranties and 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?

This is subject to negotiation and may comprise undertakings as to due authorisation, availability of consideration funds, key regulatory compliance and implementation of agreed business plans; however, PE sellers typically seek to avoid providing a comprehensive suite of undertakings beyond those indicated at question 6.2 and will typically resist restrictions on their activities post-exit and limit the length and scope of indemnity provisions.

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 negotiation. There is no standard practice other than as may be mandatorily prescribed by statutory and common law limitations on liability. Representations and covenants as to the portfolio company's operations are more properly given by management shareholders with the requisite knowledge as applicable.

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 subject to negotiation, and in our experience is less common. Warranties, etc. may speak to the expiration of the fund/SPV and warrantors in an exit scenario. Escrow arrangements of up to two years are not unusual for both PE buyers and sellers in Nigeria. Consideration may be disbursed in tranches subject to investor-prescribed performance milestones. In the event of an earn-out provision, set-off rights against the earn-out payment are also not unusual in Nigeria.

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 buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Evidence of funding in designated (escrow) accounts and concomitant arrangements for disbursement subject to specific conditions being met, are means via which comfort may be provided. Equity commitment letters addressed to the target 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.

PE transactions may involve equity financing from the PE investor and debt financing from a third-party lender. Comfort, with respect to the equity financing, is often provided in the sale purchase agreement, which generally contains a commitment for the PE investor to fund and complete the acquisition upon the satisfaction of certain conditions. Investment agreements may include warranties as to sufficiency of funds and capacity to provide funding. Comfort letters from third-party lenders in respect of the debt financing are also not unusual.

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.

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 regulatory requirements, timing, and the costs of effecting IPOs, share value following changes in share capital, and the underwriting of shares not taken up. Valuations in certain sectors and exit timelines may still be affected by the pandemic. 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 typically 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?

It is not uncommon for PE sellers to pursue multi-track exit strategies. The macroeconomic environment, capital market illiquidity, dearth of trade buyers, share valuations, political and FX risks, timing, and regulated process challenges may require flexibility in the path to exit. Exits to trade buyers and private sales remained more prevalent when compared with the number of IPOs implemented as exit mechanisms.

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 relatively high-yield instruments, including treasury bills and bonds, are not uncommon in Nigeria.

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 an electronic certificate of capital importation having been obtained from a CBN-authorised dealer bank when the original investment or loan capital is 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 NGN 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 transfer of the target above the prescribed thresholds. There are, however, exceptions to this prohibition.

Tax-deductible interest earned on loans granted by foreign connected parties to Nigerian companies is restricted to 30% of EBITDA per accounting period. Expenses incurred by related parties within or outside Nigeria will be tax-deductible only if the transaction is consistent with transfer pricing restrictions, 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 a continued increase in debt financing through

DFIs and syndicated loans in which DFIs invest in Nigerian sub-nationals to boost growth in emerging companies. The CBN, in addition to the NGN50 billion Targeted Credit Facility (TCF), which has favourable interest rates, had added US$120 million to the COVID-19 Pandemic Relief Fund, which would serve as a stimulus package to support households and MSMEs affected by the pandemic. An NGN100 billion loan to the health sector and an NGN1 trillion loan to the manufacturing sector have also been announced. Existing loan facilities are being renegotiated and restructured. Moratoriums have been granted on federal government-funded loans.

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 (0–70% depending on the tenor of the loan and grace period (including moratorium)). It is common for BuyCo residents in countries with which Nigeria has DTAs to be utilised for Nigerian PE investments and debt transactions. Nigeria currently has effective DTAs with Belgium, Canada, China, the Czech Republic, France, the Netherlands, Pakistan, the Philippines, Romania, Slovakia, South Africa, Spain and the United Kingdom.

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 following arrangements are typically considered:

(a) utilisation of SPVs incorporated in jurisdictions with which Nigeria has DTAs to reduce withholding tax on dividends;
(b) granting of long tenured loans of up to seven years and above to achieve 70% withholding tax on interest; and
(c) 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 (chargeable at 10%) are not so exempt, however, where the buyer is not related to the seller.

For reorganisations or similar transactions involving related entities, the Finance Act 2019 introduced a 365-day pre- and post-business reorganisation rule for related party business reorganisation transactions, in order for the assets transferred to be entitled to the applicable tax benefits, such as exemption from CGT, value-added tax, transfer of assets at tax written-down value, etc. The related entities must have been related for 365 days preceding the sale of the assets and the assets cannot be resold within 36 days of the initial sale for these tax exemptions to apply.

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 31st December 2020, President Muhammed Buhari signed the Finance Act 2020 into law. The Finance Act 2020 amends much tax and fiscal related legislation, including the CAMA, Capital Gains Act, and the Companies Income Tax Act. Some key amendments that may impact PE investors include:

(a) minimum tax for companies in respect of returns for the period between 1st January 2020 and 31st December 2021 has been reduced from 0.5% to 0.25% of gross turnover less franked investment income;
(b) donations made by corporate entities to funds established by the government in the event of a health crisis or pandemic are now regarded as allowable deductions for tax purposes;
(c) small companies are now specifically exempted from paying tertiary education tax;
(d) non-resident companies liable to pay tax are required to file tax returns to the Federal Inland Revenue Service (FIRS). This obligation does not apply to non-resident companies whose final tax liability in Nigeria is withholding tax;
(e) dividends in a public company listed on the Nigerian Stock Exchange that remain unclaimed for a period of six years or more now have to be transferred to a new fund called the Unclaimed Funds Trust Fund. These dividends, however, may still be claimed by the relevant shareholder at any time; and
(f) amounts in a dormant bank account that have remained unutilised for a period of six years or more must also be transferred to the Unclaimed Funds Trust Fund.

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 CAMA, the BOFIA, the Finance Act 2019 (which became effective in 2020), the Finance Act 2020 (which became effective in 2021), as well as the Merger Review Regulations and Merger Review Guidelines issued by the FCCPC, are significant laws and regulations impacting PE investors or transactions. Nigeria also signed the African Continental Free Trade Agreement (Agreement), which aims to create a single continental market for goods and services, with free movement of businesses, persons, and investments. The Agreement, which is expected to accelerate the establishment of a customs union, will also expand intra-African trade and enhance competition, and was ratified by the Federal Executive Counsel; however, it will not become law until it is ratified by the National Assembly.

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 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 varies and is subject to negotiation as to scope and materiality and to the parties' objectives, budgets and timelines. Comprehensive legal due diligence will cover the corporate structure, regulatory compliance, material contracts, debt and security, employees, intellectual property and litigation profile of the target. Multi-jurisdictional deals may be limited in scope. The target's supply chain dependency, material contracts with termination and *force majeure* provisions, due to the pandemic and its related impact, may be a specific focus. The timeframe for a detailed review can range from two to six weeks, subject to the target's records, organisation and delays with external regulatory and third-party searches and checks.

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, anti-corruption and anti-money laundering requirements under legislation and international treaties and agreements are generally prevalent in PE fund structuring, fund management and debt and investment 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?

Shareholders are generally not liable for the acts or omissions or debts of the company as the liability of shareholders is generally limited to the amounts paid or yet to be paid in respect of any shares held by the investor in a Nigerian limited liability company. In the case of an unlimited company, the liability of members for the debts of the company is unlimited. The company is a separate legal personality from its members. However, the courts may "lift the corporate veil" where a company is a sham or is being used as a tool to perpetrate illegality. A shareholder may also be liable where, to his or her knowledge, the company operates with fewer than two 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?

Strategically important factors include: choosing partners aligned with the PE investor's outlook and objectives; working with international and local advisers with Nigeria-specific expertise; and having a pragmatic and realistic approach to regulatory interactions and timelines.

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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. 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. Our private equity partners are recognised in various 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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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?

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 2020, LBO transactions of private targets dominated the transaction volume, representing 50.6% of the total PE transactional volume for that year.

In 2020, the total Norwegian M&A market experienced a decrease in volume compared with 2019 and so did the Norwegian PE market, with a 4.6% drop in reported volume compared with 2019. For deals involving PE Sponsors in 2020, (either on the buy- or sell-side) the average reported deal sizes also decreased significantly from €346 in 2019, to €130 in 2020, mainly due to the COVID-19 pandemic. The market continued to be driven by new investments and add-ons but, in 2020, we witnessed a significant drop in the number of exits and secondary, while the number of new investments increased significantly.

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.

By the number of PE transactions, TMT services and the industrial and manufacturing sectors dominated the Norwegian market in 2020, each with 46%, 11.3% and 10% of the buyout investment volume respectively, followed by the consumer sector with 8.8%, and the medical sector and the energy sector, each with 6.3% of the total deal count, respectively.

1.2 What are the most significant factors currently 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 respect, 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. However, currently, the COVID-19 pandemic is also a factor frustrating PE funds' appetite for new deals within certain sectors such as the leisure (hospitality), consumer and retail sectors, etc.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

Despite the slowdown in deal activity due to the COVID-19 pandemic during the first half of 2020, Norwegian M&A activity picked up again immediately after the summer, based on what many had hoped would be the end of COVID-19 in sight. In total, the 2020 reported M&A deal value for Norway increased from €24.548 billion for FY2019 to €25.265 billion for FY2020, while the average reported deal size increased from €286 million for FY2019 to €308 million for FY2020. What is particularly interesting is that some of the M&A activity witnessed throughout 2020 actually happened as a result of the devastating effect of the pandemic on some businesses.

We also continue to see strong momentum for new PE deals in sectors such as TMT, healthcare, pharmaceuticals, and the industrial and manufacturing sectors, which are less influenced by the COVID-19 pandemic. There is still much cash waiting to be invested. On the other hand, we expect that the COVID-19 pandemic (if it continues) most likely will result in an increasing number of insolvency cases, particularly within industries such as travel, tourism and the retail sector. At the same time, this may create a number of opportunities for investors looking to invest within these industries from a long-term perspective. It should also be noted that most PE funds seem to have managed the transition into a new workday of completely digital deal-making.

We expect that this trend of completing M&A deals via online collaboration software, and thus reducing the need for physical meetings when buying and selling businesses, will continue.

Owing to the COVID-19 pandemic, throughout 2020, the government implemented a set of temporary emergency legislation, relief programmes and other initiatives that may affect M&A deals entered into while the pandemic is ongoing, including a Temporary Competition Act setting out exemptions from certain procedural rules in the Competition Act, such as extended deadlines for the government to intervene in merger control cases. This Act remained in force until the end of October 2020, but may potentially be reinstated, depending on the situation. The Companies Act, as well as several other acts, was also amended to allow online annual meetings. Some of these amendments are still in force but may potentially be prolonged or repealed, depending on the situation.

In addition, the government introduced a scheme under which it may provide state aid to companies fulfilling certain criteria and that have experienced losses in revenues owing to the pandemic. None of these programmes have so far been deterrent to PE funds activity into the Norwegian market.

The Norwegian conservative government has not been willing to take on or actively pursue equity stakes in troubled firms. Still, a potential policy shift may happen later this year, if (as many predict) Norway has a new left-wing labour government following the September 2021-parliamentary election.

Irrespective of which position one may take in relation to the COVID-19 pandemic, the author believes many investors will continue to view Norway as a good place to invest, due to its highly educated workforce, technology, natural resources and well-established legal framework for M&A transactions. Consequently, our view is that the long-term effects of COVID-19 on PE in Norway, will most likely be limited.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

During the last decade, we have seen a number of family offices, but also smaller investment-firms, and individual investors executing PE style transactions in the Norwegian market. The main difference between the deal terms offered in such transactions is that some of these investors tend to be slightly more flexible with regard to their sweet spot for investing, the approach they take with regard to lock-up until exit, vesting structures, accepting investments in minority stakes, and the amount of leverage applied in the deal. Some of these investors tend to seek out investment opportunities in areas that have not typically been a focus for traditional PE funds, but where consolidation opportunities still exist. Examples of such investors are, *inter alia*, Ferd, Credo Partners, Icon and Hawk.

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 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 four 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 Sponsors') 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 anti-asset stripping rules, *cf.* question 10.1); rules on thin capitalisation and deductibility of interests; withholding tax ("**WHT**") 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 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 (46.4% 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 regard 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 question 2.2 (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 driver behind equity terms and the equity structures is normally the desire 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 the 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 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 that 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. In practice, most Norwegian funds seem to rely on such enforcement mechanisms in the shareholders' agreements instead of implementing lengthy articles. That said, 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).

Further, it should be noted that if the shareholders' agreement attempts to bind the directors in their capacity as directors, 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). It should also be noted 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. Norway has further 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?

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/UK nationals who reside in an EEA state or in the UK. 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. It should also be noted that, for public LLCs (irrespective of 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 ⅓ 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 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. Although, on 1 January 2020, Norway implemented a set of rules that further eases the previous strict ban of financial assistance (by amending the existing "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 (see further in section 8). On a general note, in order to be valid, related-party transactions must be approved by the board, and if the consideration from the company represents a real value exceeding 2.5% of its balance sheet amount for previous fiscal year, the board must prepare a special report to be distributed to all shareholders with a known address. In addition, such report must be filed with the Norwegian Registry of Business Enterprises. 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 (see question 11.1). If the relevant company's shares are listed on a regulated market, additional requirements apply and such agreements must also then be approved by the relevant company's shareholders' meeting in order to be valid.

Directors violating any of the formal requirements described above may, at worst, expose him/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 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. That said, to pierce the corporate veil under Norwegian law is not considered 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 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, foreign direct investment 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 the Investing Management.
- The time necessary to establish the desired investment vehicles and SPVs 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.

- It should also be noted 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.
- Finally, it should be noted that if a target company operates in sectors considered vital from a national security perspective, the National Security Act now grants the government powers to intervene and stop acquisitions of shares in such company.

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 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 2020 and into 2021.

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 Euronext Expand (formerly 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 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 Norwegian takeover supervisory authority 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 Euronext Expand), 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 (which is authorised to receive such notifications on behalf of the Norwegian FSA). 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 has directly, indirectly or through consolidation of ownership (following a stake-building process or one or more voluntary offers) 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 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). 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 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 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 fees occur, often in a range of 0.8% to 2% of the target's market-cap. Of the five public M&A offers launched during 2019, a break fee of around 2% of the offer price was agreed for one of these deals. Of the four public M&A offers launched in 2020, a break fee of

NOK 10 million (around 0.27% of the offer price), reflecting an estimate of the cost incurred by the bidder, was introduced in one such deal. In another deal, a break fee of NOK 5 million (around 0.38% of the offer price) was agreed.

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. That said, 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 (i) a private equity seller, and (ii) the 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-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 2016 and 2017, 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 2018 and throughout 2020. 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 Warranty and Indemnity ("**W&I**") 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. W&I insurances, including special claims insurances, have, however, started to become increasingly popular in the Norwegian market (see question 6.4).

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 2020, 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 2020, we estimate that close to 25% 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. 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 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 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 the 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, it should be noted 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 buyer (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 an 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 the transaction 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?

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 the 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; however, during the last few years, these deals have often materialised in a sale, while throughout 2020 and 2021 this trend shifted. Over the last 12 months we have observed a significant increase in dual-track processes being materialised in an IPO, in particular on Euronext Growth Oslo (formerly Merkur 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).

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 eight 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 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. Since the beginning of 2017 and throughout 2019, the Norwegian high-yield bond market improved significantly, at least within certain selected industries. At the beginning of 2020, Norway was hit by COVID-19 and the high-yield bond market closed down for a period. However, during the summer of 2020, the high-yield bond market started to improve and has returned more or less to its pre-pandemic status.

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?

Since 1 January 2020, certain further easing of the Norwegian financial assistance prohibition rule has now finally been adopted (see below).

As a general rule, the Norwegian public and private LLCs have been prohibited from providing upstream financial assistance in connection with the acquisition of shares in a target company (or its parent company). This prohibition prevented Norwegian target companies from participating as co-borrowers or guarantors of any acquisition-financing facilities. However, in practice, there have always been a number of ways to achieve at least a partial debt pushdown through refinancing the target company's existing debt, which should not be regarded as a breach of the prohibition against financial assistance.

Effective from 2013, the Norwegian Parliament introduced a type of "whitewash" procedure, allowing both public and private target companies to provide financial assistance to a potential buyer of shares in such target (or its parent company), provided, *inter alia*, such financial assistance did not exceed the funds available for distribution of dividend. Such financial assistance had to be granted on normal commercial terms and policies, and the buyer also had to deposit adequate security for his obligation to repay any financial assistance received from the target.

The rule's requirement for depositing "adequate security" for the borrower's obligation to repay any upstream financial assistance provided by a target in connection with M&A transactions would, however, mean that it was quite impractical to obtain direct financial assistance from the target company in most LBO transactions, due to the senior financing banks' collateral requirements in connection with such deals. The reason for this was that the banks normally request extensive collateral packages, so that, in practice, there would be no "adequate security" left or available from the buying company (or its parent company) for securing any financial assistance from the target group, at least for the purchase of the shares. With effect from 1 January 2020, this situation has changed.

First, provided the target company is a Norwegian ASA-Company, an exemption from the dividend limitation rule was implemented with effect from 1 January 2020. This exemption rule will, however, only apply if the bidder (as borrower) is domiciled within the EEA area and is part of or, after an acquisition of shares, will form part of a group with the target company. In such latter situations, the financial assistance may now also exceed the target company's funds available for distribution of dividend. This group exemption will, however, not apply if the target company is a Norwegian ASA-Company.

Second, from the same date, the requirement for the buyer (as borrower) to provide "adequate security" for its repayment obligation will no longer be an absolute condition for obtaining such financial assistance from the target company. That said, due to the requirement that such financial assistance has to be granted on normal commercial terms and policies, it cannot be completely ruled out that a bidder, in the future, may still have to provide some sort of "security" for being allowed to obtain financial assistance from a Norwegian target company. Nevertheless, as long as it can be argued the acquisition being in the target company's best interest and such financial assistance can be justified in absence of any security, after 1 January 2020, it will now be possible for a target company to grant financial assistance to a bidder without such security.

Any financial assistance must still be approved by the general meeting, resolved by at least two-thirds of the aggregate vote cast and the share capital being represented at the meeting (unless otherwise required by the target company's articles of association). In addition, the board must ensure that a credit rating report of the party receiving the financial assistance is obtained and, also, that the general meeting's approval is obtained prior to any financial assistance actually being granted by the board. The board shall also prepare and execute a statement, which must include: (i) information on the background for the proposal of financial assistance; (ii) conditions for completing the transaction; (iii) the price payable by the buyer for the shares (or any rights to the shares) in the target; (iv) an evaluation about to what extent it will be in the target's best interest to complete such transaction; and (v) an assessment of the effect on the target's liquidity and solvency.

Since 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, it should be noted 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 benefitting 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 indicates 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 the board to prepare special reports for the various group companies, and require such reports to be filed with the RBE 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, falls within the scope of such reporting requirements.

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 that 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.

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. 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. The costs will be added to the tax base 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 that are limited companies, as well as 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 EEA Member States including the EU, Norway, Iceland and Liechtenstein. Losses related to such realisations 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.) should be deductible on a current basis for corporate tax purposes under Norwegian law. Broken-deal expenses that are incurred in connection with failed acquisitions of shares (typical expenses relating to due diligence) are not 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) should be deductible on a current basis. It is important to distinguish between financing costs, which are considered interest for tax purposes, and other financing costs, as interest costs are 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). Generally, input VAT on advisory fees in relation to acquisition of shares is not recoverable/deductible for VAT purposes.

Deductibility of interest

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 interest costs can be "pushed down" into the jurisdiction that has profitable activities without the imposition of additional tax costs such as WHT. 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, rules limiting the deduction of net interest paid to related parties entered into force. The rules aim to eliminate, or reduce the risk of, the Norwegian tax base being excavated as a result of tax planning within international groups where the debt has been allocated to the Norwegian group companies. Additional restrictions on interest deductions have been implemented later. With effect from 1 January 2019, interest payable on bank facilities and other external debt have also become subject to a similar interest-deduction limitation regime, as interest paid to "related parties" for companies within a "group". The group definition includes all companies that could have been consolidated if IFRS had been applied. The original "separate entity rule" will exist in parallel with the new "group rule". In situations where a Bidco is used for an acquisition, one should assume that the "group rule" will apply for limitation of Bidco's and its subsidiaries' interest deduction. Interest cost disallowed under the limitation rules can be carried forward for 10 years, but subsequent deduction is also dependent on capacity for interest deduction, *inter alia*, within 25% of taxable EBITDA.

The "group rule" applies if the deducted net interest expenses exceed NOK 25 million in total for all companies domiciled in Norway within the same group. Where the threshold amount is exceeded, deductions are limited to 25% of taxable EBITDA on a separate company basis. It may thus be beneficial for a group to partly refrain from deduction of interest expenses to avoid exceeding the threshold. Note that the "separate entity rule" also applies to a company within a group when interest is paid to a related party outside of the consolidated group (typically where the related lender is an individual or a company not belonging to the consolidated group for accounting purposes). Two escape rules allowing deduction of interest payments on loans from third parties not forming part of any tax evasion scheme have been implemented. Under the first rule, which applies to each Norwegian company in a group separately, the equity ratio in the balance sheet of the Norwegian company is compared with the equity ratio in the consolidated balance sheet of the group. A group company established in the fiscal year or a surviving company in a merger during the fiscal year cannot apply this rule to obtain interest deduction. Under the second escape rule, which applies to the Norwegian part of the consolidated group as a whole, the equity ratio for a consolidated balance sheet of the Norwegian part of the group is compared with the balance sheet of the group. In both cases, the Norwegian equity ratio must be no more than two percentage points lower than the equity ratio of the group as a whole. Companies qualifying for the equity escape clauses may deduct net interest expenses in full, except for interest expenses to related parties outside of the group. Several adjustments have to be made to the balance sheet of the Norwegian company or the Norwegian part of the group when calculating the equity ratio. If different accounting principles have been applied in the local Norwegian accounts and group accounts, the local accounts must be aligned with the principles applied in the group accounts. Further, goodwill and badwill, as well as other positive or negative excess values in the group accounts relating to the Norwegian company or the Norwegian part of the company group, must be allocated to these entities. The local balance sheets must also be adjusted for intra-group shares and claims that are consolidated line by line in the group accounts. Shares in and claims against such group companies shall be set off against debt and total assets when calculating the group's equity ratio. The adjusted group accounts and the adjusted local accounts for the Norwegian company or the Norwegian part of the group, must be approved by the companies' auditor.

The "separate entity rule" only applies if the net interest expenses (both internal and external) exceed NOK 5 million. This rule caps the interest deductions on loans from related parties only (which do not constitute a group under the above rule) to 25% of the borrower's "taxable earnings before interest, tax, depreciation, and amortisations". 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. Also, a loan from an unrelated party (typically a bank) that is secured by a guarantee from a related party that is not a group company (*inter alia*, a parent company guarantee) will also be considered a related-party loan under this rule. 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. Also, where a related party has a claim against a non-related lender and the interest-bearing loan from the non-related lender is connected with such a claim, the loan can be deemed as a related party loan.

It should also be noted that the acquisition vehicle itself would normally have no taxable 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. Group contributions allow a company to offset taxable profits against tax losses in another Norwegian entity in the same fiscal year by transferring funds or establishing an account receivable. 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 has introduced WHT on interest payments to related parties in low tax jurisdictions. These rules apply to payments of interest from 1 July 2021. Companies are considered related if there is a direct or indirect ownership interest between them of at least 50% or if a company has a direct or indirect ownership interest in both the payer and the creditor of at least 50%, at any time during the fiscal year. Taxable payments are proposed to be taxed at 15% (gross). Exemptions apply if a reduced rate follows from a tax treaty. Further, there are also several general exemptions, *inter alia*, for payments to companies that are genuinely established and conduct real economic activity in the EEA, to a Norwegian branch of a foreign company taxable in Norway and for interest taxable under the Norwegian petroleum tax act.

Distributions of dividends

Normally, in a typical LBO, it will not be envisaged that any dividends will be made by the Norwegian holding company structure 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 WHT on dividends will need to be considered. The applicable WHT rate depends on the respective tax treaties and (typically) on the foreign shareholder's ownership percentage in the Norwegian holding companies. Norway has a broad network of tax treaties that reduce the ordinary WHT rate of 25%. It should be noted that Norway has implemented the OECD multilateral instrument for avoidance of base erosion and profit shifting, introducing a principal purpose test in many treaties. All existing treaties should be considered carefully, to analyse their current status when relying on treaty protection.

Under domestic legislation, no WHT 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 WHT 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% WHT rate (i.e. not accept treaty protection). Foreign buyers of Norwegian assets should thus be cautious when setting up acquisition structures and also include tax reviews of any prior holding structures when conducting due diligence.

Paid-in capital is an individual tax position for the shareholders. A foreign holding company that has paid in a premium to an acquisition vehicle can repay such paid-in capital with no risk of dividend WHT. In case of a dividend distribution where there is a risk for WHT, a shareholder with paid-in capital as a tax position can opt to allocate the distribution to its individual paid-in capital account, thereby avoiding dividend WHT. When setting up a Norwegian Bidco, one should thus register a limited amount as nominal share capital and the remaining equity as paid-in premium, to allow for tax-exempted distributions during the holding period, *inter alia*, in a partial exit.

It should also be noted 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 exempt from Norwegian corporate tax on the part of the receiving corporate shareholders. However, 3% of the received dividends are subject to taxation for corporate shareholders holding not more than 90% of the shares. This entails an effective tax of 0.66%. This rule should level the benefit that shareholders are allowed tax deduction for ownership costs incurred on shares subject to participation exemption. Under the Norwegian GAAP, dividends received from wholly owned subsidiaries can be recognised in the accounting year the dividend is based on, hence making the basis for a distribution from the parent company in the same accounting year. This may allow for a tax-effective and quick cash flow to handle bridge financing in an acquisition.

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. Norway does not impose dividend WHT on liquidation dividends. However, 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 foreign entity. Foreign-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. That being said, it is nevertheless critical that any exit can be structured in such way that it does not trigger any WHT 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 question 2.3). As employers' contributions to the social security tax are deductible, the effective rate for the employer should be lower than the standard 14.1%. 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. Further, it is 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 the Investing Management obtaining shares at a discount must be reported to the Norwegian tax authorities immediately after the transaction in the relevant tax period.

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. This would allow for a tax-exempted rollover at a later sale or deferred taxation of the capital gain until management distribute the capital gains from their holding companies. 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 unless it can be documented that the shares 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. Generally, arrangements initiated by the principal or the employer, which reduce the risks for the Investing Management, increase the risk of reclassifying capital gains to salary for the management. As this would both increase the tax burden and social security obligations for the management and the employer, diligent planning should be in place for any management incentive plans.

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. Some limited-tax incentive schemes are available for the discounted acquisition of shares, with options for employees to acquire shares in the employing company. However, the general tax rule allowing a tax-exempted discount for purchasing shares is very limited and must include all employees. The general rule of taxation of options in employment only allows for the potential beneficial timing of the taxation. Employees in small start-up companies are entitled to a more substantial tax incentive by way of deferring the taxation of options until the acquired shares are realised by the employee. Nevertheless, the maximum deferred benefit is NOK 1 million and there is both a minimum and maximum holding period for the incentive to apply. The final total tax burden is also potentially higher compared to an ordinary acquisition of shares without deferred taxation for both the employer and the employees. A consultation paper for expansion of tax incentives on options in companies up to their 10th year from establishment was issued by the government in June 2021. The proposal includes a significant tax incentive compared to the current tax rule, but it is uncertain whether such a proposal will be approved by the Parliament.

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 the 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 the 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? Loans from a Norwegian company to any of its direct or indirect shareholders being private individuals holding more than 5% of the shares in the company (or to such shareholders' related parties) will be taxed as dividends on the part of such individual shareholder (see question 9.4). Nevertheless, the taxed amount will increase the shareholder's individual paid-in capital position and can be distributed as a dividend subsequently without taxation. The 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. Links that are too close 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.

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 carried interest to Managers in exchange for their services. Only when there is a strong connection between Norwegian resident active owners' personal labour contribution and the Carry, can the Carry be taxed as salary. As long as the profit in its nature is a result of the ownership and the increased value is not solely a result of the Managers' personal work, there is not sufficient connection to reclassify capital gains to salary. This was broadly laid down in the Supreme Court ruling in 2015. The tax authorities continue challenging Managers and general partners and claim that carried interest to management's holding companies can be taxed as operating income subject to corporate tax at 22% rather than tax-exempted capital gains on shares. Such a view was recently also supported by a decision from the court of appeals and now appears to be generally accepted in the market. Nevertheless, depending on what capital the carried interest is based on, if the risk for losses is greater than the limited partners' and the allocation of the Carry,

Carry may still be defined as capital income. Further, reallocation of carried interest between the general partners and the Manager based on general transfer pricing principles is also an issue that the tax authorities follow up where there are different tax consequences. Introduction of the principal purpose test ("**PPT**") and simplified limitation of benefits ("**LOB**") in the tax treaties with respect to dividend WHT may have impact on some structures; however, under the prevailing structure in Norway (which is the Luxembourg holding structure), the WHT exemption would still generally rely on the EEA exemption for corporate shareholders that are not established as wholly artificial arrangements for the purpose of avoiding tax.

In addition to introducing interest WHT as described above, WHT on interest and certain rental payments has also been introduced and will be effective from 1 October 2021. Such WHT can be imposed on payments to related parties, i.e. if there is a direct or indirect ownership interest between them of at least 50%, or if a company has a direct or indirect ownership interest in both the payer and the creditor of at least 50%, at any time of the fiscal year. Only payments to related parties in in low tax jurisdictions will be subject to such taxation. Taxable payments are proposed to be taxed at 15% (gross). Exemptions apply, *inter alia*, if a reduced rate follows from a tax treaty or the recipient is genuinely established in the EEA and carries out real economic activities in an EEA country.

Effective from 2020, Norway introduced a statutory general anti-avoidance rule ("**GAAR**"). This was, in many respects, legislation on the previous broad's non-statutory anti-avoidance doctrine. It is thus important to consider the risk for disallowance of losses or reclassification of transactions where intermediary transactions are carried out for the purpose of saving taxes. However, carrying out a tax-exempted demerger followed by a tax-exempted sale of shares of the demerged company is still generally considered possible.

Due to the COVID-19 pandemic, the Parliament passed a number of temporary adjustments to the tax legislation, in order to ease the consequences of locking down many business areas. These adjustments mainly involve the postponement of reporting and payments of taxes.

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 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. It should also be noted 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. 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.)?

In a structured process, PE investors tend to limit diligence scope 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, as 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".

The criminal liabilities category includes 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 capital gains from foreign funds to Norwegian investors

PE funds would normally be AIFs not subject to the beneficial tax rules applicable for Securities Funds. However, in a 2019 ruling by the Supreme Court, a fund was considered a Securities

Fund, whereby also capital gains on investments in shares outside the EEA are tax exempted. Whether or not capital gains from investments in AIFs are subject to participation exemption for Norwegian corporate investors depends on whether the fund is considered transparent or non-transparent for tax purposes, and the location of transparent fund's portfolio companies. The classification of a fund in its country of residence does not mean that the fund must be classified equally for Norwegian tax purposes. For instance, a foreign non-transparent fund could be deemed as transparent for Norwegian purposes if one or more investors have unlimited liability for the fund's obligations and a foreign transparent fund could be deemed non-transparent if the general partner does not have a real economic interest in the fund, e.g. by right to a Carry or at least 0.1% of the ownership of the fund. A transparent fund would as a starting point be comprised by participation exemption independent of its country of residence. If the fund only invests in portfolio companies resident within the EEA, there are generally no tax issues for Norwegian corporate investors. However, negative tax consequences for Norwegian investors would occur if the funds invest in portfolio companies in low tax jurisdictions in the EEA or generally outside the EEA. If more than 10% of the funds' equity investments are not comprised by the Norwegian participation exemption method in a two-year period, realisation on interest in the fund itself would not be comprised by tax exemption and hence subject to Norwegian taxation. However, this 10% rule does not impact taxation of capital gains that fund the receives and distribute, which would be embraced by participation exemption provided that the underlying investment is covered by participation exemption. The participation exemption would also apply for an investment by the fund in a company in a non-low tax jurisdiction outside the EEA, provided the funds hold at least 10% of the shares and voting power for more than two years. However, if the investment is made through a holding structure, e.g. a US portfolio company owned via CI, the structure could have negative tax consequences as capital gains from the portfolio investment would be taxable even if the funds qualify for participation exemption. In a non-transparent fund the residency of the portfolio company would be less important for the taxation of the investors. Returns from such a fund established in a within the EEA would normally be subject to a participation exemption for Norwegian corporate investors, unless the fund is a resident in a low tax jurisdiction not genuinely established and carrying out activities within the EEA. Luxembourg and the Netherlands could be considered low tax jurisdictions under Norwegian rules. Further, even if the fund should be classified in a specific way for Norwegian tax purposes, one should also consider whether CFC regulations or specific hybrid consideration could apply changing the taxation for Norwegian investors. A sale of shares in a transparent fund to a foreign investor, could trigger exit taxation for the Norwegian seller on latent capital gains on portfolio companies not qualifying for a participation exemption in the fund. The Norwegian tax classification of a fund and its investment, as well as the fund's investment structure in addition to the complexity of different sets of rules, are thus important for Norwegian corporate investors to consider in order to understand whether capital gains would be tax exempted or not in Norway.

Tax treatment of a management fee paid by a 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 different tasks carried out by such Managers on behalf of the fund. In this regard, the Supreme Court concluded 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 appointed an expert committee to evaluate and propose relevant amendments to the existing Norwegian legislation resulting from EU amendments to the Markets in Financial Instruments Directive ("**MiFID II**"), the Transparency Directive and the implementation of the Market Abuse Regulation ("**MAR**"). This committee has now published seven reports proposing several amendments to the STA. Some of the proposals so far have also resulted in a number of amendments to Norwegian legislation regulating public takeovers in Norway. On 12 June 2019, the Parliament adopted a bill implementing the Prospectus Regulation into Norwegian law by amending chapter 7 of the STA. In June 2019, the Parliament adopted a bill implementing the MAR into Norwegian law, but this bill did not enter into force until 1 March 2021. From the latter date, chapter 3 of the STA was amended accordingly. As a consequence, a target's decision to delay disclosure of inside information has now been amended, so that the target (issuer) only has to notify the takeover supervisory authority about such delay after the relevant information has been disclosed to the market.

A seventh report was published in January 2021. The report contains proposals for certain amendments to the rules on supervisory authority, sanction competence and appeal schemes. The report proposes, *inter alia*, that the task, as offering authority, be transferred from the OSE to the Norwegian FSA, and that the delegation of the supervision with the ongoing duty to provide information and the deferred publication cease. The committee proposes that the Stock Exchange Appeals Board be closed down and that an appeals board be established under the Ministry of Finance for cases in the securities market area. We expect that the proposed amendments will be implemented into Norwegian law in 2022 at the earliest.

Changes to the OSE's issuer rules, etc.

Throughout 2020 and as of 1 March 2021, the OSE has also implemented a set of changes to the issuer rules on the OSE, Euronext Expand, and Euronext Growth Oslo. It should be noted in this respect that the OSE has updated its relevant rule books for the various exchanges (formerly "continuing obligations of stock exchange-listed companies"). In contrast to the former situation, where the OSE had its own rule books for various financial instruments and its own rules for admission and current liabilities, respectively, all these sets of rules have now been collected in Rule Book II.

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 submitted a report concerning the Norwegian rules on voluntary and mandatory offers, with a particular focus on the current limited regulation of the pre-offer phase.

It is unclear when the Parliament will adopt these amendments into Norwegian legislation, although we do not expect the proposed changes to be implemented into Norwegian law until 1 January 2022 at the earliest. However, in April 2020, the Parliament adopted a rule under which a regulation can be issued setting out rules for calculating the offer price in cases where there is a need for an exception to the above main rule or where it is not possible or reasonable to use the main rule for calculating the offer price. At the same time, it resolved to replace the "market pricing" alternative with a more balanced rule set out in a separate regulation. However, the repeal of the "market pricing" alternative has not yet entered into force. Due to the COVID-19 pandemic, a temporary regulation for calculating the offer price was implemented with effect from 20 May 2020, expiring on 1 January 2022.

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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?

As a major market in Central and Eastern Europe (CEE) and a member of the European Union, Poland offers many opportunities to private equity firms. Yet, as is the case for most countries in this region, due to historical reasons, there is relatively low number of potential large-cap targets. On the other hand, the Polish economy experienced a continued growth for over almost 30 years, which resulted in the creation of the Polish mid-cap companies target (with values in the range of EUR 10 million to EUR 100 million). Therefore, private equity firms find many targets for buyout in Poland, particularly in the expansion/growth sector. Another feature of the Polish economy is a large number of directly or indirectly foreign-controlled potential targets.

These factors contribute to the fact that Polish companies are normally indirectly acquired by large international private equity firms, while often directly acquired by European or Polish private equity players.

Moreover, all types of private equity transactions, such as buyouts (including leveraged buyouts) as well as trade sales or secondary sales, are visible in Poland.

No major shift in trends occurred in 2020. A relatively strong sell-side position continued to be evidenced by a growing number of auction processes and increased use of warranties and indemnities insurance policies (W&I insurance).

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

The crucial factors resulting in an increase of the number of private equity transactions are:

- a substantial number of mid- and low-cap targets in Poland facing leadership and generation change, which translates to buy opportunities for private equity players;
- Polish companies that form a part of international (mostly European) groups are in a relatively healthier financial situation than companies in Western Europe. Therefore, in case of issues at the level of the group, one of the remedies is sale of Polish (or CEE/Southeast Europe (SEE)) operation and investment proceeds in the core markets for the given group; and
- the e-commerce and IT sector is flourishing in Poland, as in many other countries. Interesting and innovative add-on targets for takeover may therefore be found in Poland.

Growing fiscal pressure and frequent changes in tax and financial reporting legislation can inhibit private equity transactions. However, the dynamic increase of M&A transactions in general suggests that the aforementioned unfavourable circumstances are not considered by the buyers as prevailing.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

The COVID-19 pandemic only affected selected sectors, while allowing other sectors to progress at the same time; the overall impact of the pandemic is therefore limited. The slowdown in transaction numbers could have been noticeable in the first half of 2020 but transaction activity has since continued to increase. According to available data, the number of transactions increased in 2020, although their aggregate value was lower than in 2019.

The government support packages deployed in 2020 have not yet significantly affected private equity activity in Poland. Nevertheless, a combination of factors such as: (i) public authorities' actions aimed at revindication of the aids granted in 2020 due to errors made by the applicants while filing their application for support; and (ii) a lack of similar government intervention in 2021, are likely to result in an increased of number of potential target companies, especially in a distressed situation.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

Polish sovereign fund *Polski Fundusz Rozwoju* plays an increasing role as both a private equity investor as well as the fund of funds. It applies private equity firm standards yet, at least for the time being, its strategy seems to be accumulating investment and keeping them in a long term.

Moreover, growing awareness of private clients results in their expectation of selling their businesses on the terms and conditions that are normally used by private equity firms (especially if the buyer is an industry player and there is no expected post-closing involvement of the seller in the operations of the target).

2 Structuring Matters

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

Private equity investors tend to use EU-based SPVs to buy Polish targets. However, especially if the transaction is an add-on investment, either EU industry operating subsidiaries acquire the target or a Polish SPV, being a limited liability company to acquire the target, is created. In larger deals, e.g. mid-cap market, or deals involving external financing or where a rollover shares are planned to be issued to the seller, a traditional structure with a holding company (HoldCo) and acquiring company (BidCo) is created.

2.2 What are the main drivers for these acquisition structures?

The main drivers are: hitherto investment practice of the given private equity fund; taxes; financing providers requirements; and the purpose of the acquisition.

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

Typically, Polish and European private equity firms structure their equity with the use of Luxembourg or Dutch investment vehicles. The management is offered with shares in Polish targets or, rarely, in entities at upper level. Moreover, phantom shares (or similar instruments) are seen to be offered to the Polish management team.

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

Structuring deals where a minority stake is acquired, regardless of whether the buyer is a private equity firm or not, requires: (i) careful drafting of control rights, often to be implemented in the articles of association (statutes) of the target; and (ii) envisaging and properly drafting the exit mechanism (normally including tag-along and drag-along options). Particular solutions depend on the relative bargaining powers of the parties and the purpose of the investment. For further details, please see section 3 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?

Typically, the management equity ranges from 3% to 10%. However, if a target is highly dependent on the know-how of the management, that stake may rise to 30%. Related contract provisions normally regulate: (i) lock-up periods; (ii) put and call options (often triggered by good/bad leaver events); (iii) tag-along and drag-along rights; and (iv) non-compete and non-solicitation clauses.

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

A bad leaver is normally defined as precisely as possible, in a manner that enables assessing if given circumstances result in the qualification of the management equity holder as a bad leaver, without a need to evaluate general clauses. Sometimes, however, a clause specifies that where the management member may be dismissed for "due reason", he/she will be regarded as a bad leaver. A good leaver is, on the other hand, defined usually as a management member not being 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 governance arrangements vary depending on the shareholding structure (for obvious reasons, they are more complex in companies with more than one shareholder). Typically, such arrangements regulate: (i) the appointment/dismissal of members of the governing bodies (private equity buyers tend to appoint at least one management board member for control of day-to-day operations purposes); (ii) veto rights and matters requiring consent of the shareholders' meeting or of the supervisory board (major matters would normally require the consent of the private equity buyer in a form of resolution of a pertinent target's governing body controlled by the buyer); (iii) share transfer restrictions and rights of first refusals; and (iv) profit/liquidation proceeds distribution.

While the articles of association (statutes) are available to the public (they must be submitted to the registry court for its effectives) and breach thereof may be effective towards third parties in specific cases, the other aforementioned instruments are not generally disclosed to the public and breaches of them do not normally affect transactions with 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?

Yes, private equity buyers are usually vested with such veto rights. The less shares they hold, the less matters are covered by such veto rights.

In case of minority shareholding, a private equity buyer will enjoy blocking rights with respect to such matters as changes of share capital or disposal/encumbering of shares in the target or of material part of target's business/operations. Moreover, in such circumstances, the private equity buyer may be entitled to appoint one (or more) members of the management or supervisory board.

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 a limited number of decisions taken by the target company without authorisation at the shareholder level will result in ineffectiveness of given action. There are no specific rules limiting veto arrangements, except for a general rule that the shareholders in similar situations should be treated equally (which, in specific situations, may mean that excessive rights or minority shareholders included in the articles of association might be challenged).

At the level of the director (management board member), veto rights are also possible but will be effective internally only (i.e. contracts concluded in breach of such veto will be valid).

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 particular duties resulting from law. The articles of association (statutes) of the target company and, especially the shareholders' agreement (if any), may be regarded as a contract between the parties (shareholders). Hence, breach of such "contract" by one party may result in the other party's claim for damages. Duties and obligations of the private equity majority shareholder are therefore set forth in such articles of association (statutes) or shareholders' agreements.

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 a rule, content of the shareholders' agreements may be freely shaped within the general limits of freedom of contracting. Therefore, provisions of the shareholders' agreement may be challenged if, for instance, they can be regarded as by-passing compulsory provisions of commercial companies' laws, such as those related to distribution of profit. The shareholders' agreements may be subject to foreign law.

Non-compete and non-solicitation provisions, as ancillary restrictive, are subject to general limitation resulting from EU and Polish legislation aimed at the protection of fair competition.

Moreover, to the extent the non-compete or non-solicitation clauses concern actions of a third party, not having direct contractual relationship with the buyer (e.g. the seller's affiliates or spouses), which is fairly typical especially in the case of an acquisition of a family business, these should be carefully drafted as there are doubts as to whether such limitations will be effective at all.

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?

Most commonly used types of commercial companies in Poland have a dualistic system of governing bodies, i.e. a management board manages and represents the company, while a supervisory board is vested almost exclusively with control and supervision powers with respect to the management board. Consequently, the obligations and corresponding liability of the supervisory board members are far narrower than those of the management board members. The management board members are by operation of law authorised and obligated to run the company and, in principle, they act collectively.

The distribution of tasks between the management board members has a mostly internal effect. That, in turn, translates into an obligation of all board members to implement an effective management system in which it is not possible to fully exclude liability of the management board members for the actions (or omissions) of fellow management board members. For instance, in case of bankruptcy of a limited liability company, management board members may be found liable for the debts of such company if they have not filed an application for bankruptcy in due time (there are also certain additional requirements in that respect).

There is no specific risk for the private equity firms due to nominating its representatives to the boards of the portfolio companies.

Regulated entities (e.g. financial institutions) should also comply with more specific management and corporate governance rules, in many cases published as a recommendation of the supervisory authorities.

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?

Conflict of interest must be disclosed to the company concerned. Moreover, in practice, it is recommended that the portfolio company consents (by way of the management board or supervisory board resolution, as the case may be) to holding by the directors of a position in other companies, including the investor or another portfolio company.

4 Transaction Terms: General

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

The most time-consuming issues for closing the transactions are those related to the antitrust clearances and regulatory notifications or clearances. Similarly, certain certificates (notably security-related) and public licences, in a limited number of areas, may require renewal or reassessment, which are normally carried out between signing and closing of the transaction.

Comparing to some other EU jurisdiction Polish FDI rules (save for dozens of special targets) are not triggered in case the buyer (its controlling entity) is from an OECD or EU/EEA country.

As regards disclosure obligations and financing issues, they vary from target to target but overall do not affect timing of the transaction materially.

Finally, depending on the quality of the due diligence materials and report, the process of arranging for W&I insurance may take several weeks and should be started as soon as practicable.

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

Every year, the Polish market follows more and more global trends; for instance, it might be noticed that the sale process is more structured and formalised on the sale-side and the role of W&I insurance increases (as well as sellers' willingness for "clean exits"). No general domestic trend is discernible.

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 private equity bidder/buyer is regarded, as a rule, as any other investor within the acquisition process. In particular, the acquisition of shares representing 33% of the votes of the public target, triggers the obligation to make a tender bid for shares representing up to 66% or 100% shares. Similarly, the acquisition of shares representing 66% of the votes results in an announcement being required of a public tender offer for 100% of shares.

This legislation implies a careful structuring of negotiation, due diligence and pre-signing phases, which, on one hand, limit the scope of involved individuals, especially on the part of the target, and, on the other hand, allow a quick and effective pre-signing process to be conducted.

Additionally, a public tender offer requires the prior financing of the commitment papers in a form of a bank guarantee of funding or a cash deposit covering the entire bid stake.

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

When making the public tender offer (which is, as a rule, applicable for exceeding 33% and 66% of the votes in the target public company), the bidder may indicate few specific conditions, which must be met to bound him by the public offer. Moreover, the buyer of 95% of shares may initiate a forced squeeze-out procedure and, regardless of the level of held shares, place a secondary public offer.

The main protections need to be sought in the documents signed with the majority stake seller. The protections in the tender offer are almost non-existent.

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, there is a growing appetite for limiting the potential post-transaction exposure by W&I insurance and, consequently, for payment of the entire purchase price as soon as possible. Normally, the seller prefers to sell not only the operating target but also its HoldCo, if any. Moreover, locked-box structures are preferred by the sellers.

Buyers, taking into account results of due diligence, are aiming at securing at least a portion of the claims they may have under identified (and indemnified by the sellers) risk by placing a portion of the purchase price with the escrow account (alternatively, retained amounts or seller's loans are sought).

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

A private equity seller often refuses to give warranties related to the operation of the portfolio company if it did not have full control over the management board. Hence, the warranties of such seller relate to title, authority and capacity. Even if the private equity seller offers warranties related to the underlying business, they are limited compared to similar warranties usually expected from the management team or from non-private equity sellers.

Normally, the management team only provides warranties if it also shares its shares in the portfolio company or if it is otherwise incentivised to proceed with the exit (e.g. through rolled-over shares).

As regards indemnities, those related to taxes are seen in many deals. Other types of indemnities vary from deal to deal.

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 undertakings largely depend on the deal structure and the underlying portfolio entity operations. In a typical "locked-box" transaction, crucial covenants concern the leakage and operations of the portfolio company between the accounts date and the closing. In a standard "completion accounts" deals, the covenants mostly concern the operation of the business between the signing and the closing, including – to the extent permitted by the competition regulation – certain buyer's consents required for a limited set of major decisions exceeding the ordinary scope of business of the target.

In case a transaction is subject to the antitrust clearance, the cooperation of the sellers may be material for getting the clearance. Hence, respective undertakings of the seller are drafted. The same applies to transactions being subject to regulatory clearances (e.g. concerning financial institutions) where the quality of data provided by the seller and thorough regulatory and financial due diligence disclosures are of utmost importance.

Indemnities addressing due diligence findings are common in deals where sellers are not private equity firms. In "locked-box" transactions, leakage is indemnified on a EUR per EUR (PLN per PLN basis) basis.

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 noted above, the representation & warranty (or W&I) insurance is more and more popular in Poland. In a standard insurance policy, i.e. not enhanced and not specific title or tax insurance, the average value of the insurance is 30–50% of the enterprise value in consideration for a premium starting from 0.4% of the enterprise value. The standard policy does not cover, among others, known risks, fairly disclosed matters, forward-looking warranties, fraud or criminal liability. In terms of policy limits, in the vast majority of cases, the policy is back-to-back with the related acquisition document. The retention amount in some cases may be as low as 0.3–0.4% of the 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?

As mentioned above in the answer to question 6.1 above, since the scope of warranties offered by a private equity seller is narrower than those offered by the management team, the scope of liability is different. Namely, as a rule, caps for liability of the private equity seller are significantly lower than of the management team. Typically, for a standard transaction, such caps amount to *ca.* 20–30% of the total purchase price (for non-fundamental warranties) and claims may be pursued for all non-fundamental warranties, usually within 18–24 months, while for tax warranties it is usually six years and for title 10 years. Indemnities are also usually capped.

However, both in case of any seller's warranties, its liability is typically excluded to the extent incorrectness of the warranty resulted from the disclosed information.

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 unwilling to provide any security deferring payment of the full price. However, in specific cases (especially if the buyer has greater bargaining power), that relatively small fraction of the purchase price is escrowed to cover potential liability under the identified risk with respect to which parties are not in a position to agree on the likelihood of materialising such risk.

In the case of sellers not being private equity firms, escrow accounts are rather common.

Other types of securities, e.g. pledges, are not common, as such collateral security may complicate third-party financing of the transaction or a consent of the sellers' financing bank. Please also see the answer to question 6.1 above.

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 buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

The typical comfort measures may include providing copies of final equity commitment letters and financing documentation. In the absence of compliance/performance by the buyer, the sellers would be entitled to damages only.

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 Poland. Consequently, they are negotiated case by case and one may not provide their typical terms.

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?

Challenges related to IPOs are rather standard across the EU and result mostly from formalisation of procedure, the need for involvement of additional advisors (especially for the purpose of preparation of a comprehensive information memorandum), and interaction with financial market regulatory authority (which, in turn, adds more uncertainty and time consuming actions).

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

Lock-up periods normally range between six and 18 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?

Based on our practice, dual-track exit processes are currently not very common in Poland. Even assuming that such dual-track process is considered by the seller, the vast majority of transactions are realised through private sales.

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 transactions are mostly financed by banks in the form of loans. Usually, for mid-cap and larger transactions, financing is secured by foreign banks or syndicates including foreign and domestic lenders. For smaller deals, where the transaction may not be financed entirely by the private equity fund, the financing is normally provided by banks where the main operations of the private equity firm concerned are located.

A seller's loan may be found (but is not common) in deals where the post-closing involvement of seller(s) being the management of the portfolio company is required.

Private debt financing has been seen more frequently in recent years.

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?

It is quite common to secure the external financing of the transaction through the establishment of pledges over the shares held in the target company.

Moreover, if a target company is a joint-stock company (or a limited partnership related by shares), the financial assistance restriction rules apply both to direct financing by the target and guarantees granted by them. Due to such restrictions, such financial assistance is rare in M&A transactions in general.

Additionally, for all types of the target being a commercial companies, granting a collateral security for the purpose of financing an acquisition of a given target is subject to further restrictions and consideration such as: (i) consideration of the target interest and related management board liability for acting detrimentally to the interests of the given company; (ii) rather vague and unprecise (under Polish law) concepts of over-collateralisation; and (iii) potentially limited effectiveness of such collateral securities in case of the insolvency of the target.

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

As mentioned above, we have seen an increasing involvement of private 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?

Private equity investors should be aware of numerous major amendments to the Polish tax law. Currently, the actions taken by the investors in organising tax-efficient structures are impacted by:

- strict rules on withholding tax withheld by Polish payers requiring due diligence to verify the status of the beneficial owner of the payment and the resulting possible temporary freezing of withholding tax funds in the tax office's account;
- limitation of expenses on certain intangible services (such expenses may constitute tax deductible costs up to the amount equal to 5% of "tax EBITDA");
- thin capitalisation rules (limitation on tax deductibility of debt financing financial costs exceeding PLN 3 million (approx. EUR 666,000) is limited up to 30% "tax EBITDA");
- limitation of CIT exemption for investment funds and elimination of the exemption for closed-end investment funds;
- limited partnerships and certain general partnerships become subject to CIT (from 2021);
- new rules for taxation of the sale of real estate companies using a local real estate company as payor (from 2021);
- implementation of ATAD 2 (from 2021, taxpayers are required to analyse the payments made for the use of hybrid instruments or hybrid entities in the payments, under penalty of disqualifying the taxpayer's deductible expenses for the payments);
- GAAR clause and "little" tax anti-abuse clause (the latter may result in the denial of an income tax exemption for dividends if such exemption results in no taxation or a reduction in the taxable amount without an adequate business justification); and
- Mandatory Disclosure Rules (the obligation to report information about "the tax schemes" to the Head of the National Treasury Administration).

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 quite common for the local management teams to apply preferential rules for PIT settlement on participation in the incentive programmes. The PIT Act provides for the possibility of deferring the taxation of share-based compensation, until the sale of the shares, at which point the income will generally be taxable as a capital gain. It is important, however, that a given programme meets the conditions specified in detail in the PIT Act, among other things:

- the incentive plan is implemented and the participants acquire shares on the basis of a resolution of the general shareholder meeting of a joint-stock company;
- the joint-stock company is either an employer of the participants or a parent company of the employer of the participants, which directly or indirectly holds a majority of the voting rights in the employer; and
- the shares are of a company with a seat in an EU or EEA Member State or in a country with which Poland has concluded a double tax treaty.

A capital gain from a share sale would be subject to a flat tax rate at 19%. Extra solidarity tax of 4% applies to annual income over PLN 1 million (approx. EUR 222,000).

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 for management would be the deferral of tax payment until any disposal proceeds are received with a minimum level of tax available. Typically, tax consequences of such actions may be safeguarded through obtaining a tax ruling.

Generally, tax neutrality of mergers or an exchange of shares may be preserved based on the local implementation of EU legislation subject to meeting certain conditions provided in the Polish provisions, including, in particular, the condition that the purpose of the transaction cannot be tax avoidance or evasion.

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?

Recent changes in the tax laws have shown a tightening of tax regulations impacting private equity investors (see question 9.2 above).

However, recently, the Government officials presented the main assumptions behind the possible introduction of a new plan to stimulate the economy – the so-called "Polish deal". The planned changes should include new tax reliefs for investors and expansion of the scope of IP BOX relief and R&D relief.

The implementation of the institution of the "590 ruling" (a new instrument to secure the tax position of strategic investors investments in Poland) and a new "Polish Holding Company", with some preferential treatment for dividends taxation (e.g. more liberal conditions to apply a dividend exemption) and new participation exemption relief, is also planned.

The Ministry of Finance also intends to establish an "Investor's Desk" for strategic investors from Poland and abroad. It is intended that key investors will be directly and comprehensively serviced by the designated officers at the Ministry of Finance.

Unfortunately, the Government has not published any draft legislation of the new Polish deal. The effective date of the new regulations has not yet been specified, but some changes are supposed to enter into force as of January 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?

We do not anticipate any private equity-related-only legislation in Poland. Nevertheless, various new legislation has been considered or discussed that may affect M&A transactions in general – for instance, those related to public takeovers.

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

No. Based on our practice, we believe that private equity investors are not subject to more thorough scrutiny than other investors, assuming that there are no money laundering and financing terrorism concerns (in that respect Polish law essentially implements the AML legislation of the European Union). However, in case of targets being banks or insurers, we expect that any non-industry investor may face enhanced investigations by the regulatory authorities comparing to an industry investor.

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.)?

As a rule, fully fledged due diligence reviews are conducted. In case W&I insurance is expected, the materiality thresholds are relatively low. The due diligence review reports are, in most cases, prepared as a red-flag or issue reports only. Vendors' due diligence reports or fact books are common in the case of secondary sales conducted by private equity sellers. Please see also the answer to question 10.4 below.

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 recent years, we have seen increased interest of the private equity potential buyers in pursuing compliance due diligence review including anti-bribery- and anti-corruption-related matters. In transaction documentation, this translates into enhanced representations and warranties given by the sellers in these areas. The trend seems to mostly be driven by the fact that US and UK investors first started to put emphasis on these aspects.

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, any investor will not be found liable for liabilities of portfolio companies being limited liability company or a joint-stock company. There are exceptions with respect to potential ineffectiveness or intragroup transactions and obligations to reverse (financial) effects of such transactions if any creditor of the portfolio company was affected; however, such circumstances are very rare in practice.

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?

We do not see any special factors applying to private equity investors only.

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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?

Private equity in Portugal has experienced significant growth despite the financial crisis and sovereign debt crisis, which loomed over the country until 2014. According to the latest data available (the Portuguese Securities Market Commission – "CMVM", 2019), value under management by private equity players has been steadily rising since 2003, reaching upwards of €5.1 billion by the end of 2019.

Turnaround or distressed transactions have still been the most relevant types of private equity deals in Portugal in the last few years maintaining a (albeit uncertain) lead (28.8% of value invested), followed by growth capital investment (22.9% of value invested). Venture capital (start-up, seed and early stage) investing is also seeing a substantial rise in relevance, now ranking at third place with 17.4% of value invested.

Sector-wise, the main sectors invested by private equity are real estate and construction, manufacturing, and information technologies.

It is implausible that these market dynamics will continue following the wake of the economic downturn caused by the COVID-19 pandemic (and subsequent looming recovery). However, given the lag in the availability of the relevant data, it will take a considerable amount of time before we can know for sure the effects the health crisis and lockdown measures will have on the industry.

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

Prior to the COVID-19 pandemic, some of the most relevant trends that were encouraging transactions in Portugal were: (i) low interest rates and an accommodative monetary policy from the European Central Bank; (ii) the launching of public tenders by State-owned entities to capitalise companies, such as tenders to award EU funds to entities organised as private equity fund managers; and (iii) the use of private equity funds as conduits for obtaining investment residence permits, which also encourage fundraising and consequently private equity and venture capital transactions in Portugal.

While the pandemic is expected to be subdued in the short term in Europe and there are now signs of economic recovery, the sheer magnitude of the economic effects of the COVID-19 pandemic makes it too early to tell which factors will shape the private equity industry (in any time horizon). Please see question 1.3.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

The long-term effects of the pandemic for the private equity industry remain, at this stage, uncertain. In respect of the factors that were driving the push towards greater levels of private equity investment, fallout from the pandemic crisis has the ability to greatly disrupt them, as such: (i) a likely increase in expected inflation rates may cause central banks to abandon their very "loose" monetary policy measures, both of which may hurt portfolio companies' returns and levels of investment in private equity funds; (ii) conversely, the European Economic Recovery Programme may actually increase government support for emerging companies through grants and tenders for participation by investment intermediaries such as private equity fund managers; and (iii) there is also uncertainty as to what the level of interest of foreign individuals in obtaining residence investment permits will be after the crisis is over. In this respect, it is worth noting that the Portuguese Government has approved more stringent rules for golden visa eligibility through the subscription of units in funds (i.e. by increasing the minimum amount of investment from €350,000 to €500,000).

Government measures to stabilise the economy (e.g. moratoria, lay-off incentives) have had the benefit of avoiding large-scale insolvencies and unemployment, perhaps hurting prospects of turnaround funds looking to achieve opportunities in such a space.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

Yes. In relation to "traditional" private equity transactions, we are seeing "family offices" or individual wealthy investors also stepping into the space. Their approach relative to private equity investors is usually more long term.

Where venture capital transactions (start-up, seed and early stage) are concerned, corporate venture capital units of large companies are also participating. These investors are not only focused on pure financial returns, but are also integrating into their investment rationale the ability of the invested company to contribute to the overall business of the sponsor (innovative products or services, technology transfers, etc.).

In infrastructures, we are seeing pension funds competing with traditional private equity investors for assets with long-term regulated revenues.

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 limited partners ("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 (the CMVM).

Under Portuguese law, only the management entity can manage/take decisions for the private equity fund and there are no "general partners" affiliated with management with decision-making powers.

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.

Investments using private equity funds are an efficient way for various institutional investors to pool money into alternative asset classes that potentially offer higher yields than public equities or bonds, while avoiding the operational risks and regulatory hurdles that 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 into 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 depend essentially on the mode of management departure: if management are deemed a "bad leaver", unvested shares are acquired at nominal value; or alternatively, if management are considered a "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 is required 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 that would allow them 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 a 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. whose 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 director 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 shareholder 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.

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 that 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 are therefore 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 that restrict 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 their voting right in exchange for "special advantages" (i.e. prohibition of vote-selling).

As regards 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), while non-compete provisions 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 them 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, whose 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 that 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, foreign direct investment 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) and formalities related to employment matters, notably town hall meetings and opinions from employee representative structures;
d) waivers from competition authorities;
e) deals in some regulated sectors (especially banks, insurance companies and other financial institutions) require prior approval from the respective regulatory authorities; and
f) critical infrastructure transactions involving investors outside of the European Economic Area ("EEA") are generally required to be reviewed by the government.

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.

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 – recently acquired by a consortium of pension fund managers).

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 effectively limit the protections that can be afforded to private equity investors, such as recommendations 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?

Consideration structures in the price payable by private equity investors in Portugal to shareholders of portfolio companies often include "closing accounts" mechanisms, whereby the price changes according to variations in cash, (net-)debt and working capital from a reference date to closing date.

Earn-outs are also common (buy-side) price variations, notably in management buy-out transactions or other deals when the selling shareholders are expected to continue to play a key role in the business.

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 (i) a private equity seller, and (ii) the 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 and environmental matters, fraud, and matters known to the buyer during due diligence or not covered by the due diligence at all.

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 common 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 those 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 benefit the buyers.

Private equity buyers, on the other hand, prefer having (and frequently do have) escrow accounts with part of the price in deposit.

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 buyer (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 buyer-friendly deals, financing is sometimes even established as a condition precedent to closing.

In case of non-performance of funding obligations, the seller's typical remedy is to claim for damages (or terminate the agreement if the same has not yet "closed").

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.

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, even more so, the issuance of high-yield bonds.

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 that exist are private placements subscribed by banking syndicates (choosing bonds over traditional loans, notably for tax reasons).

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 making leveraged buyouts harder to structure (and with limitations, notably in what concerns the terms of the security package).

When planning raising debt financing, "interest stripping" rules under Portuguese law should also be taken into account, which limit the deductibility of financial expenses.

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 since the sovereign debt crisis and ensuing recapitalisation measures.

With the end of the moratoria imposed by the government as a measure to protect the economy from the fallout of the COVID-19 pandemic, a new wave of defaults (such as in real estate financing transactions) is expected to occur.

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 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. 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% nor the exemption rule are applicable when: (i) the beneficiary is an entity resident in a blacklisted jurisdiction; or (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% CIT withholding tax.

Off-shore 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 their shareholders do not receive any special treatment (i.e. a 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% corporate and personal income tax 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, as in many other jurisdictions, to 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 compensation packages, whether they are in the 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 personal income tax ("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:

a) 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.
b) Employees must have owned 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 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 nominal corporate income 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, without interruption, 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, however, appear to be 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 private equity funds that 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 that 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 arising from the regime implemented by the Alternative Investment Fund Managers Directive ("AIFMD"):

a) their incorporation is subject to the prior authorisation of the 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) the 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).

As of January 1, 2020, Decree-Law no. 144/2019, of September 23 came into force. Among other innovations, this statute imposes more stringent regulatory requirements for the incorporation of private equity fund managers below the "AIFMD" thresholds (notably regarding the adequacy of qualified shareholders and members of corporate bodies of such fund managers).

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 that 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 residents may be subject to review by the Portuguese government. Transactions that have not been previously cleared and are subject to opposition by the government are null and void.

This regime has, thus far, not been affected by the approval of Regulation (EU) no. 2019/452 of the European Parliament and the Council regarding analysis of foreign direct investment in the European Union.

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 Fifth 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 the purpose 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 is the controlling structure of its clients (the fund LPs) and who is the ultimate beneficial owner of such LPs. 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.

Anti-bribery provisions (i.e. by imposing obligations on the parties similar to those that would apply if the FCPA and the Anti-Bribery Act were in force in Portugal) are also increasingly finding their way into deal documents, notably with international private equity investors.

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 their 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 resolution of disputes in the State courts (which is why transaction agreements usually contain arbitration clauses).

The economic crisis and uncertainty generated by the COVID-19 pandemic has, thus far, not impaired private equity investment too much; however, it remains to be seen how the recovery will play out and affect this asset class.

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Morais Leitão, Galvão Teles, Soares da Silva & Associados (Morais Leitão) is one of Portugal's leading full-service law firms, with more than 80 years of experience. The firm is internationally recognised for high levels of service and cutting-edge solutions. Specialised legal services in the main areas of law and in different sectors of the economy are a benchmark of the firm, leading to its involvement in the most important operations in Portugal, as well as in high-value cross-border transactions and disputes. With a team of more than 200 lawyers, Morais Leitão has its head office in Lisbon and offices in Porto and Funchal (Madeira Island). To support clients' international strategies, Morais Leitão developed a network of associations with local firms in Angola, Cape Verde and Mozambique – Morais Leitão Legal Circle – which offers integrated multijurisdictional teams.

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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?

Despite the pandemic and impact of COVID-19, private equity in the Kingdom of Saudi Arabia (the "Kingdom" or "Saudi") continued to soar. The prominent forms of private equity transactions in the Kingdom that dominated 2020 were: (1) direct strategic acquisitions, notably in the healthcare, education, and energy sectors, and the key transactions being the privatisation of the Saudi Medical Services Company, a subsidiary of Saudi Arabian Airlines via the sale of its majority stake to Dr. Soliman Abdel Kader Fakeeh Hospital Company, Al Motaqadimah Schools' USD 2.9 billion deal with the Saudi Ministry of Investment (previously known as the "Saudi Arabian General Investment Authority") for the development of around 58 educational compounds, and EIG Global Energy Partners' USD 12.4 billion infrastructure deal with Saudi Aramco; (2) fund of fund investments into regional private equity and venture capital ("VC") funds, which were the result of the deployments of certain government investment programmes, notably Saudi Venture Capital and the Public Investment Fund's JAD; (3) VC equity and convertible equity investments, which amounted to USD 152 million VC funding, compared with USD 98 million in 2019, according to the Magnitt Saudi VC report 2020 during the year, with a particular focus on the e-commerce, fintech, delivery and logistics, and telemedicine sectors; and (4) single asset fund real estate investments, mostly to build and sell or lease residential properties in the major cities.

On the smaller scale of private equity, the Kingdom also witnessed the effective launch of a number of angel investment syndicates, which target to invest in start-ups and early-stage companies with high growth prospects.

While most deals in 2020 were in the VC side of the private equity, large cap private equity concentrated in education, healthcare, food & beverage, and energy. It is anticipated that private equity focus will move to chemicals, pharmaceuticals, renewables, medical equipment, and logistics in 2021 as these sectors witness consolidations in light of global economic trends.

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

The regulatory framework in the Kingdom is constantly being developed for the purpose of accommodating local and foreign investors. The Ministry of Investment ("MISA"), which is the authority responsible for overseeing regulatory procedures relating to foreign investments, introduced new flexible and more relaxed regulations that removed previous restrictions on foreign investors, such as allowing foreign investors to own properties in Makkah and AlMadinah and introducing an instant licensing regime, which are expected to result in an increase in foreign direct investment in the two holy cities specifically and the Kingdom generally. That said, and while almost all business sectors are now open to foreign investments, the shallowness of the capital markets and the lack of acquisition financing continue to be dragging forces on private equity transactions.

Additionally, the Capital Market Authority ("CMA"), which is the body responsible for governing and licensing investment funds, has issued a number of notable amendments in its efforts to attract more investors. These regulatory developments included: (i) the removal of foreign ownership restrictions on unitholders in a CMA regulated fund; (ii) issuance of relaxed requirements in relation to obtaining Authorised Persons licences, which relaxed the requirements to obtain fund management licences; and (iii) decreasing the minimum capital requirement for fund management licences. This has resulted in the creation of an attractive ecosystem for local and foreign investors.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

Despite the impact of COVID-19, Saudi witnessed a surge in its deal value. In 2020, Saudi witnessed a 73.4% increase in deal value in comparison to 2019, against a 75% decrease in deal count. The increase in deal value was as a result of closing major transactions rather than entering into more deals.

With respect to government intervention, the Saudi governments have taken a number of steps during the pandemic to mitigate the negative impact on its economy. The governments' efforts can be summarised as follows:

(i) the creation of an economic vehicle worth SAR 50 billion from banks and financial institutions dedicated to support SMEs; and
(ii) the Public Investment Fund ("PIF") established a new investment vehicle with the purpose of investing in VCs and private equity firms dedicated to investing in SMEs; and
(iii) the Ministry of Human Resources and Social Development allocated SAR 17 billion for the purpose of aiding entities facing economic constrains and guaranteeing job stability.

The Saudi Central Bank ("SAMA") instructed Saudi banks to offer temporary debt relief to their individual borrowers in the form of the restructuring of loans and suspension of various fees. Moreover, the General Organization of Social Insurance ("GOSI") offered refunds to employers on work visa fees, and a relief of penalties relating to expired work visas or residences. The General Authority of Zakat and Tax offered extensions to the Zakat and Tax filing deadlines and payment dates, which lasted through 2021.

The pandemic had the effect of shifting investment funds' focus to benefit from the accelerated digitisation of the Saudi economy, including the hyper growth of e-commerce and related fields. The digitisation effects on the economy, and the central role private equity funds will play in it, are likely to become permanent fixtures as consumers are unlikely to revert to less convenient modes of transacting, and the economy witnessed the ability of private equity to accelerate growth in a manner that directly yields consumer benefits.

Additionally, the pandemic depressed certain company valuations, especially in negatively impacted sectors, such as construction and building materials. This has triggered strategic acquisitions beyond what was previously seen in the market.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

Strategic acquisitions are the most common form of private equity transactions in the Kingdom, and they customarily involve privately held businesses as buyers and sellers. In such transactions, private companies enter into joint ventures. As such, in addition to traditional private equity firms, private companies play a huge role in the private equity ecosystem in the Kingdom.

2 Structuring Matters

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

The most common forms of business acquisitions in the Kingdom are acquisition of shares in a target company or acquisition of the underlying business assets of a target company. The choice of form differs based on a number of factors, notably due diligence results. Nevertheless, the acquisition of shares is more common in Saudi than the latter.

Furthermore, the main legal forms commonly involved in acquisitions in Saudi are limited liability companies ("LLCs") and joint-stock companies ("JSCs"). Both forms are governed by the Companies Law issued by Royal Decree No, M/3 dated 28/01.1437H corresponding to 11/11/2015G.

2.2 What are the main drivers for these acquisition structures?

As mentioned in question 2.1, acquisition of shares is common in the Kingdom due to its cost-effectiveness and efficiency. In such structure, the acquiring company will not be burdened by the need to transfer employees, obtain further licences, and enter into new sale contracts (where applicable). Additionally, in a share purchase, the acquiring company also inherits the target company's liabilities. As a result, a share purchase transaction demands a more involved and detailed due diligence. As such, while share acquisition saves both time and costs, it results in transferring the liabilities of the target company to the acquiring company. Asset acquisitions may be executed through either purchasing all the assets of the target company or through choosing certain assets.

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

Because strategic acquisitions form a significant part of private equity transactions, the equity in the transactions is mostly structured in a very simple manner: ordinary shares owned by all shareholders, including management or through employee ownership programmes. This is furthered by: (1) the legal regulatory restrictions placed in respect of preferred stock, where the Companies Law prescribes to a large degree the rights attributable to preferred stock, which exclude voting rights; and (2) the fact that the dominant corporate form in Saudi is the LLC, and LLCs are limited by law to issue ordinary shares.

That said, it is common for transactions involving funds to be structured via foreign holding companies that own the Saudi-based target company. Such structuring permits more flexibility in the equity structure, and the common equity structure where this is applied is for the investors to own voting preferred shares while management own ordinary shares.

Fund managers commonly receive carried interest of 20% of fund returns, mostly following European waterfall. The carried interest in a Saudi fund is paid as a fee, and not as distribution on a class of units.

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

Investments into LLCs and JSCs, where the investor is taking a minority interest, customarily involve the grant of minority protections to the investor, including veto rights in respect of certain reserved matters, both at board and shareholder level, tag-along rights and, in certain scenarios, a liquidation preference. It is also customary for investors, including minority investors, to require management lock-ups and minority drag rights. These rights are customarily detailed in shareholders' agreements that are negotiated and entered between the parties.

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?

With the exception of venture financing, management equity grants tend to range between 10% and 20%. Grants are customarily subject to vesting over four years and the company customarily retains a right to re-purchase the shares upon departure.

In venture financing, founders customarily own a majority of the shares through the initial financing rounds by investors. Founders customarily get diluted beyond owning a majority of the shares after the third round of financing.

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

Customarily, good leave scenarios are limited to involuntarily leave, such as incapacity or death. Bad leave designations are attributed to departures prior to a certain negotiated period, and departures for cause, including fraud and wilful misconduct. We do see circumstances where bad leave designations are further elaborated to include failing to diligently attend to the company's business.

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?

In LLCs and JSCs, the governance structure entails establishing a board of directors that includes investor representatives, and the establishment of certain reserved matters that require the approval of the investor director(s). These reserved matters customarily include the approval of business plans, annual budgets, major corporate actions, management compensation, and debt ceilings.

Investors also customarily negotiate designating certain decisions to be reserved for the vote of the shareholders, with veto rights over such decisions to investors. This helps the investors address concerns relating to the fiduciary obligations placed on directors, and how the investors may vote in scenarios where their interests diverge from those of 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?

As noted above, private equity investors customarily negotiate veto rights to their nominated directors over major corporate decisions. These reserved matters cover business plans, related party transactions, and disposal or acquisition of assets that exceed a certain assigned cap. We customarily see such rights granted even where the investors take minority positions, provided that the minority is meaningful (i.e. not less than 10%).

Additionally, private equity investors in LLCs may be granted veto rights by virtue of the Companies Law, which will be reflected in the target company's articles of association ("AoA"). Art. 174(1) of the Companies Law provides that the capital of the company may be increased subject to the affirmative vote of all shareholders. As such, where an investor rejects an increase in the capital, such rejection serves as a veto vote. Additionally, art. 174(2) further states that the AoA of an LLC may not be amended unless the affirmative vote of 75% of the shareholders has been obtained. As such, the Companies Law enforces certain restrictions that can operate as veto rights to investors who are shareholders in an LLC.

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 must be in line with the Companies Law. Where a veto item overlaps with the Companies Law, the Companies Law prevails. As such, when drafting the shareholders' agreement, one needs to assess its validity in conjunction with the Companies Law of the Kingdom and the AoA of the target company, in order to avoid diluting veto rights otherwise preserved where applicable.

With respect to director veto rights, directors should remember that they are subject to legal fiduciary obligations in respect of their decision-making, including the exercise of veto rights, which oblige them, in general terms, to act for the benefit of the company. As such, the exercise of director veto rights should always be within the confines of director fiduciary obligations.

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 not typical duties owed by private equity investors to minority shareholders; however, when minority shareholders have more experience in the management of the company or in fact are the founders of the business, they are granted management roles by having board seats allowing them to continue the management of the company including the appointment of the nominating the C-level employees.

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 is considered enforceable provided that no provision goes against Shariah principles or the Companies Law of the Kingdom.

With respect to the limitations imposed on the shareholders' agreement, while Saudi law generally recognises indemnities and liquidated damages, certain restrictions may be enforced where damages or indemnities are presented before a Saudi court. Where damages are payable, the quantum of damages is assessed on the basis of the loss actually suffered and Saudi law will almost never award punitive or consequential damages. As such, if liquidated damages are challenged, a Saudi court may not enforce the payment of all liquidated damages should they be found to be excessive. The Saudi court would assess the fairness and reasonableness of the liquidated damages prior to enforcing them. Similarly, indemnities are subject to the same fairness and reasonableness test should they be challenged before a Saudi court.

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 liability of the directors nominated by private equity investors is identical to that of the other company directors. Pursuant to art. 165 of the Companies Law, directors are generally liable in instances where they act in bad faith, violate the AoA and Companies Law, or cause harm/damage to the company. Additionally, courts grant discretion to directors in respect of business decisions made in good faith, akin to a "business judgment rule"; however, decisions involving a conflict of interest customarily present a limit to such discretion, and courts can find directors liable to make the company whole of costly decisions made by conflicted 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?

Usually, the shareholders' agreement and the AoA regulate this issue by imposing an obligation on any director in the board pursuant to art. 71 of the Companies Law to notify the board of directors of any direct or indirect interest he/she may have. In the event such board member fails to disclose any conflict of interest, the shareholders have the right submit a petition to the judicial authority to invalidate any decisions made based on such conflict of interest obliging the concerned director to return any profit or benefit realised therefrom. Additionally, it is customary for shareholders to require that directors not be permitted to vote in respect of transactions where they are conflicted. This point should be considered in depth by private equity clients in light of their overall investment direction.

4 Transaction Terms: General

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

As a significant number of companies in the Kingdom are family-owned businesses, they tend to transfer from one generation to another. When the first generation of shareholders transfer their ownership to the second generation, feuds tend to occur. Said feuds hinder the process of acquiring and/or purchasing shares. As such, feuds amongst the shareholders are considered a major issue, impacting the timetable for completing transactions.

Following the point on family businesses, legal due diligence request lists may result in delays in completing transactions due to the generational changes. While due diligence in itself does not hinder the execution of transactions, some private companies struggle to provide all the due diligence items requested due to the constant change in management or ownership. As such, the target company takes time in providing all requested items to commence the due diligence process and therefore impacting the timetable for transaction completion.

In addition to the above, term sheets are considered relatively new in the Saudi market. As such, more time is spent in negotiating them rather than jumping to drafting the necessary agreements to affect the transaction. Thus, in VC transactions, the negotiations related to the term sheets result in delaying the closing of transactions.

Lastly, the General Authority of Competition ("GAC"), in its efforts to combat monopolistic behaviours and practices, requires entities to notify it where a transaction results in possessing a dominant position, therefore constituting economic concentration (which is defined to include companies with a revenue of SAR 100,000,000 (combined)) in the Saudi market. As such, where a private equity transaction is to trigger economic concentration, the notification to GAC and approval process may result in affecting the timetable for transactions completion. The GAC notification and/or approval process customarily takes three or four months.

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

We noticed that acquiring companies have been demonstrating interest in investing in healthcare, education, agri-food, and technology sectors in their efforts to stray from oil and gas and government-backed sectors.

The banking sector also witnessed a number of major M&A activities, such as the merger of SABB and Alawal in 2019, and the National Commerce Bank and SAMBA in 2020. As such, the discernible trends revolve around the focus on the aforementioned sectors.

That said, we have not seen a recent trend in transaction terms in Saudi.

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?

Applicable laws in the Kingdom do not stipulate challenges that may be faced by private equity investors in public-to-private transactions. Nevertheless, public company acquisition regulations do apply, and stipulate certain notice and tag requirements that must be adhered to by private buyers of publicly listed companies.

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

This is not applicable.

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 private equity transactions, the preferred consideration is cash, which is customarily paid following the satisfaction of certain conditions precedent pursuant to a share subscription or purchase agreement entered into by and between the buyer and the issuer/seller. In certain strategic acquisitions, the buyer can pay through share issuance to the sellers but, due to the complexity involving valuations, this form of consideration is not the most common.

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

This usually depends on the business; for tech companies, intellectual property warranties are very important, along with warranties covering the company's finances. Additionally, warranties covering assets, contracts, and regulatory compliance are customarily given. Fundamental warranties are also always included, covering: (i) validity of legal existence; (ii) ability to enter into transactions/agreements; and (iii) no violation and compliance with applicable laws.

Buyers are customarily entitled to be warranty claims or be indemnified in respect of sellers' breaches of warranties, usually with the standard *de minimis* floors and caps.

Additionally, private equity directors should expect indemnities for directors and officers against losses arising from mistakes unless such mistakes were caused by wilful misconduct, fraud, bad faith, or forgery, and towards losses arising from the directors' performance of their duties in conformance with all applicable laws.

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?

Customarily, transaction documents include interim covenants restricting the conduct of business between signing and closing the acquisition transaction. Additionally, management or founders are subject to non-compete covenants and lock-up undertakings that restrict their ability to compete and/or sell.

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?

While transactions tend to carry extensive representations and warranties, it is highly uncommon for parties to bind representations and warranties insurance in respect of acquisitions. We have come across such insurance policies in Saudi.

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

Customarily, sellers' liabilities are capped at the consideration paid by the buyers. That said, *de minimis* floors and, at times, liability buckets, are agreed between 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)?

While escrowed security is not common in private equity transactions in Saudi, earn-out clauses that permit price adjustments following closing based on escrowed amounts are. Liability for warranty breaches is customarily covered through direct 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 buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

The Kingdom recently issued the Commercial Pledge Law and the Law on Securing Rights with Movable Assets issued by Royal Decree No. M/94 dated 15/8/1441H corresponding to 28 April 2020G. Said laws have provided security with respect to sourcing financing since such issue has been neglected prior to the issuance of both laws. As such, it is anticipated that the enactment of the laws aforementioned will boost acquisition financing in the Kingdom. At this time, acquisition financing is highly uncommon.

The courts in the Kingdom can be reluctant to mandate specific performance for violation of contractual obligations, such as the obligation to close on the purchase of shares or assets, favouring awarding monetary damages *in lieu* of forcing parties to complete an agreed transaction.

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

While break fees are customary to protect the buyers, which incur costs in relation to the purchase, reverse break fees, whereby the buyers would pay the sellers should they fail to consummate a transaction, are not typically agreed in Saudi. That said, where it was clear that the sellers will incur significant transaction costs, they may wish to negotiate such provision.

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?

Customarily, IPO preparation is a time-consuming exercise that can take upwards of one year. Private equity sellers looking at IPOs for an exit should consider conducting an IPO readiness analysis on the target to assess the time it will take to prepare the target for an IPO.

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

Pursuant to art. 69 of the Rules on the Offer of Securities and Continuing Obligations issued by the Board of the CMA, private equity sellers are customarily locked up from selling their shares upon an IPO for a period of six months. That said, sellers may wish to apply to the Capital Market Authority for an exception, which may be granted on a limited basis. Additionally, private equity sellers should also be aware that the Companies Law prescribes that founding shareholders (determined at the time the company is incorporated or converted into a joint-stock company) cannot sell their stock for a period of two years from incorporation or conversion. This can function as a natural lock-up period, and is important to consider to correctly time the conversion or incorporation of the listing vehicle.

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 Saudi public equity market remains small, and while IPO is a viable exit path, it is not the main exit path. Acquisitions remain the main exit path for private equity sellers. As such, it is customary for sellers to pursue a dual-track exit process to increase the likelihood of an 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).

As mentioned earlier, acquisition financing is not customary in Saudi. Nevertheless, it is anticipated that the Commercial Pledge Law and the Law on Securing Rights with Movable Assets issued in 2020 can potentially offer further governance with respect to securing financing for 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?

This is not applicable.

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

This is not applicable.

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?

Saudi companies are subject to a two-tier tax structure, whereby companies pay income tax of 20% in respect of the portion of income equal to the foreign-owned shares in the company, and pay Zakat of 2.5% of the enterprise value in respect of the Saudi-owned shares in the company. In addition, foreign shareholders are subject to a 20% capital gains tax in respect of share sales, and a dividend withholding tax of 5%. The use of offshore structures is common in private equity transactions in Saudi, and it is recommended that investors consult tax advisors to determine the most appropriate ownership structure for the target company to render an effective tax footprint.

Companies operating in the oil and gas sector are subject to a higher bracket of income tax.

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 individual income is not subject to tax, management-driven tax structures are not considered.

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 matter to be considered in the event of disposal of shares or the restructuring thereof is the capital gains arising out of the transaction. Sellers are encouraged to consult tax advisors to consider whether an efficient transaction structure may be identified to reduce their tax footprint, including the sale of Saudi assets through dispositions of holding offshore vehicles.

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?

This is not applicable.

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 mentioned under section 1 above, the CMA and MISA have been developing their relevant laws related to investment funds and foreign ownership in the Kingdom, creating an attractive private equity ecosystem for both local and foreign investors.

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

This is not applicable.

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 a huge factor in private equity deals that could either affect a transaction or put an end to it. The timeframe associated with the due diligence drastically varies depending on the nature of the transaction and the form of acquisition, but two to five weeks is a reasonable timeframe for an LDD exercise.

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 has been no visible impact.

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 investors should gain an understanding of the rules surrounding piercing the corporate veil, mostly prescribed pursuant to the Saudi Companies Law. Thin capitalisation and a lack of appropriate accounting can serve as grounds for the shareholders to be held liable for company 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?

Factors that could affect private equity investors in the Kingdom tend to revolve around Saudi's applicable law, which includes Shariah principles. The applicability of Shariah principles affords Saudi courts a wide discretion in determining outcomes of claims. As such, many transactions in Saudi elect the laws of England and Wales or the DIFC to govern documents and/or subject disputes to arbitration.

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Hammad & Al-Mehdar Law Firm was founded in 1983 in Jeddah, Saudi Arabia, and has grown to become a prominent private practice Saudi firm in the Kingdom and the GCC. The law firm boasts a leading local presence supported by international capabilities. Hammad & Al-Mehdar is headquartered in Jeddah, with offices covering the three major cities in Saudi Arabia (Riyadh and Dammam).

Hammad & Al-Mehdar provides a full suite of business and corporate legal services in all major areas of Saudi law, working on cutting-edge, complex and high-value transactions and disputes.

Hammad & Al-Mehdar maintains a strong specialisation in servicing privately held businesses, with unrivalled expertise in private equity, business and transaction structuring, private construction works, commercial, intellectual property, corporate governance, and regulatory advisory services.

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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?

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 robust in 2020, although at a lower value of approximately US$5.2 billion from December 2019 to November 2020, compared with US$6.5 billion in 2019. Singapore continues to be at the forefront amongst its neighbours in driving private equity deals – the energy and technology sectors, in particular, have been generating keen interest.

Noteworthy private equity transactions in Singapore in 2020 include: Equis Development Pte Ltd, which raised US$1.25 billion in its 2020 funding round with Abu Dhabi Investment Authority and other investors; Grab Holdings Inc, which raised US$706 million in its 2020 funding round with Mitsubishi UFJ Financial Group Inc; and the Ontario Teachers' Pension Plan Board's US$360 million investment into Singapore-based Princeton Digital Group Pte Ltd.

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

Singapore is one of the most developed markets in South-east Asia and is known for its low taxes and tax incentives for foreign investors, its stable political-economic environment, and for being home to a skilled pool of working professionals. Singapore has also recently introduced a new corporate structure for investment fund vehicles, the variable capital company ("**VCC**"), which took effect on 14 January 2020. As at March 2021, at least 250 VCCs have been incorporated in Singapore. These factors and regulatory developments continue to draw private equity investors and make Singapore a natural entry point for investment activities in the region.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

COVID-19 has had varying effects across different industries in the private equity market, naturally dampening growth in traditional sectors like tourism and aviation while causing a surge of activity in sectors such as fintech, technology and healthcare.

Private equity firms are now particularly focused on investments into sectors that are expected to grow including digital health, e-commerce, e-learning and cybersecurity, although valuation of assets in sectors dampened by COVID-19 will remain a challenge until the effects of COVID-19 are more fully understood.

Distressed mergers and acquisitions ("**M&A**") activity has not taken the limelight primarily because of extensive government intervention in the economy. For example, Singapore small-to-medium enterprises were permitted to defer performance of their contractual obligations under the COVID-19 (Temporary Measures) Act. Further, the government has extended its temporary bridging loan programme, which provides borrowers with access of up to S$3 million for business needs, with interest rate capped at 5% *p.a.* and Enterprise Singapore taking a 70% risk share, until 30 September 2021.

These governmental measures have provided businesses with short-term relief and are perhaps one of the reasons that Singapore was the only South-east Asian market to see growth in private equity deals and deal value in 2020.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

According to data from the Monetary Authority of Singapore, the number of family offices in Singapore increased by five times between 2017 and 2019. These family offices have typically invested in funds or co-invested alongside fund managers as shadow capital, although some larger family offices are now managing direct investments. Unlike traditional private equity firms, family offices generally have a network of connections, which allows them to have the first pick when it comes to smaller-to-medium business transactions.

The presence of shadow capital is also becoming increasingly prominent across South-east Asia.

2 Structuring Matters

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

Private equity investments are commonly structured with an off-shore holding company acting as the pooling vehicle, which will then own a Singapore-incorporated master fund. However, Singapore's fund management landscape is changing as more private equity fund managers are now leveraging on the attractive features available via the incorporation of a VCC, e.g., the ability (which is unavailable to traditional Singapore companies) to pay dividends out of capital.

2.2 What are the main drivers for these acquisition structures?

The main driver for these acquisition structures is tax efficiency, and in particular Singapore's network of double taxation treaties. As for VCCs, the main attractions are the flexibility the vehicle provides in the issuance and redemption of its shares and the cost efficiencies that may arise from using common service providers across the umbrella and sub-funds.

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 convertible and redeemable preference shares and convertible debt. Management may be granted cash bonuses payable on the achievement of specified targets or phantom share option schemes.

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

When taking minority positions, private equity investors should consider governance issues (discussed in section 3 below) and methods of ensuring returns, e.g., through contractual targeted internal rate of return ("**IRR**") provisions. Failure to meet the targeted IRR, for example, could trigger the investor's option to compel the company to redeem its redeemable preference shares or to exercise a put option.

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?

Ten per cent to 20% of equity is typically allocated to management. Management equity vesting periods usually last three to five years. It is not uncommon for management equity to be subject to: (i) "good leaver" and "bad leaver" provisions; and (ii) a "drag-along right" to require management to co-sell its shares in the target to procure a sale of the entire share capital of the company.

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

This will depend on the specific terms agreed upon in the contractual agreement between the management equity holder and the company. Typically, persons who are dismissed for cause will be treated as bad leavers and persons who cease to work for the company without cause will be treated as good 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 are typically set out in the shareholders' agreement but can also be included in the company's constitution.

Typical arrangements include quorum requirements, reserved matters, and board or committee appointment rights. A company's constitution is made available to the public upon incorporation with the Accounting and Corporate Regulatory Authority ("**ACRA**"). Shareholders' agreements do not need to be filed with ACRA and confidentiality as to the terms therein is therefore preserved.

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 major corporate actions, even if it takes a minority position. Such veto rights typically include major acquisitions, disposals, financing and new share issuances, winding-up, material changes in its business 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?

Veto arrangements at both the shareholder and director level will typically be enforced by Singapore courts; however, with reference to directors, when exercising veto rights, they are still subject to their overriding fiduciary duty to the company (please see question 3.6 below for details on this duty). If there is concern about a potential conflict of interest between the director's exercise of his veto rights and his fiduciary duties, this may be addressed by giving such veto rights to the shareholders instead.

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, private equity investors do not owe any duties to minority shareholders such as management shareholders (or *vice versa*).

However, aggrieved minority shareholders may seek recourse under Section 216 of the Companies Act if the affairs of a Singapore company are being conducted in a manner oppressive to it. If the court finds that oppression is proved, the court may make orders 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)?

As shareholder agreements are private contracts governed by the usual contractual principles, Singapore courts will generally uphold the provisions of a shareholder agreement, and its breach may be remedied via damages, injunctions and specific performance, subject to the usual constraints of illegality – for example, non-compete and non-solicit provisions are restraint on trade clauses, which are unenforceable unless the party seeking enforcement can show that the restraining provision is reasonable and is intended to protect a legitimate proprietary interest.

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 must appoint at least one director who is ordinarily resident in Singapore. Certain persons (e.g., an undischarged bankrupt or a person who has been convicted for offences involving fraud or dishonesty) are prohibited from acting as directors of Singapore companies. As fiduciaries, directors also have duties owed to the company. Such duties include the common law duty to act *bona fide* in the interests of the company and statutory duties under the Companies Act to: (i) declare any conflicting interests at board meetings (Section 156); and (ii) at all times act honestly and use reasonable diligence in the discharge of his duties (Section 157). Non-compliance with these statutory duties is an offence punishable by fines and/or imprisonment.

These directors' duties must be carried out not only by persons formally appointed as directors, but also by "shadow directors" (persons who direct or instruct the board despite not being a board member – this could potentially refer to the private equity investors who nominate board directors of portfolio companies).

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 should disclose the nature of any actual or potential conflicts they may be facing to the board, as soon as is practicable after the relevant facts have come to his knowledge, and abstain from voting on the resolution.

4 Transaction Terms: General

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

The Singapore Code on Takeovers and Mergers ("**Takeover Code**") applies to public-to-private transactions. As such, the major issues affecting the timetable of such transactions include the timelines imposed under the Takeover Code and the approvals that must be acquired from the Securities Industry Council, e.g., in relation to any proposed break fee arrangements.

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 ("**SGX**") and the notice period for the shareholders' meeting.

Public-to-private transactions are further subject to certain funding requirements, e.g., the financial adviser to the acquirer is required to issue a confirmation of financial resources, and this may take some time as the financial adviser will need to conduct financial due diligence in this respect.

Certain industries are also regulated (e.g., payment services, telecommunications) and acquiring specific approvals in such instances may impact the timetable. Further, anti-competition agreements or M&A that may result in a substantial lessening of competition within Singapore markets are prohibited under the Competition Act and must be assessed and approved by the Competition and Consumer Commission Singapore ("**CCCS**"). The timeframe for assessment is approximately 30 working days (for a Phase 1 review) and 120 working days (for a Phase 2 review).

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

Warranty and indemnity insurance has become increasingly common in recent years. Another key trend is that private equity investments are being held for longer periods, which has resulted in increased negotiations between parties on, e.g., extending maturity dates.

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 must comply with the Takeover Code. The Takeover Code imposes rules that can materially alter a deal's structure. For example, once the offeror has announced a firm intention to make an offer, it cannot withdraw the offer without the Securities Industry Council's consent. This means that a firm announcement must only be made after deal financing is secured.

The Takeover Code further mandates that all shareholders should be treated equally, which prevents investors from offering equity sweeteners to key shareholders and in turn can result in higher purchase prices.

Public companies and their subsidiaries are also not permitted to provide financial assistance for the acquisition of their own shares unless doing so would not materially prejudice the interests of the company or its shareholders or the company's ability to pay its creditors. To approve of the company providing financial assistance, steps that need to be taken include that the board must pass a resolution setting out the grounds for its conclusions that the company should give the assistance and that the terms for the giving of assistance are fair and reasonable to the company.

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

Such protections imposed on a target include break fees and irrevocable undertakings.

A break fee must be a genuine pre-estimate of loss, not a penalty. The Takeover Code specifies that a break fee must be minimal, i.e., no more than 1% of the value of the offeree company. The Securities Industry Council's approval must be sought for break fees and any break fee arrangement must be fully disclosed in the announcement and offer document.

The acquirer will often obtain irrevocable undertakings from key shareholders in order to secure votes in favour of the 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?

While private equity investors on the sell-side tend to prefer locked-box mechanisms, consideration structures with post-completion audits and subsequent working capital adjustments are more commonly seen in the sale of private companies.

Unlike corporate buyers, private equity buyers are generally less inclined to provide protection guarantees for the purchase price.

Depending on whether the parties desire a clean break after the acquisition, earn-outs may be used. Specifically, a seller would not be inclined to accept earn-outs if it wishes to divest at the end of its funding round. On the other hand, private equity buyers commonly use earn-outs to incentivise key management sellers.

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

Private equity sellers will usually provide fundamental warranties on title, capacity and authority. Management is generally expected to give the buyer extensive warranties and the seller representations as to management matters if it holds substantial equity in the company. If management only holds a minority stake, sellers may increase the scope of warranties, subject to limited liability caps of between 10% and 30% of the consideration.

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 limited material adverse change clauses, which provides assurance that the business will continue in the ordinary course between signing and completion.

Agreements also usually provide for a long-stop date – if closing conditions imposed upon both parties are not fulfilled by this date, the agreement will terminate. These closing conditions are usually subject to robust negotiations as parties are generally determined to achieve deal certainty.

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 warranty and indemnity insurance is now common practice and is a prerequisite for many private equity investors. Sellers use it to fill any gaps in the extent of protection and coverage, while buyers use it to improve the likelihood of their bid being accepted in competitive situations.

Typical excesses range from 0.5% to 1% of the enterprise value and typical policy limits range from 10% to 30% of the purchase price. Typical carve outs/exclusions include forward-looking warranties (e.g., that the target will achieve certain profit targets post-completion), penalties or fines, purchase price adjustments, known issues, certain tax risks (e.g., transfer pricing), certain environmental risks, fraud 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?

A seller's liability for fundamental warranties is commonly capped at an amount equal to or less than the consideration. For non-fundamental warranties, common caps are between 10% and 30% of the consideration. It is also common practice to include general limitations such as time limits on claims and a *de minimis* threshold. See question 6.2 above for typical management warranty limitations.

If, in the course of conducting due diligence, risks are identified, an amount of the purchase price will usually be set aside to satisfy claims arising from such risks materialising.

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, it is rare for private equity sellers to provide any escrow amount as security, even where known risks are identified. Whether security is eventually provided for in the agreement will hinge on the respective bargaining power of the parties.

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 buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

For private acquisitions, equity commitment letters are often given by the buyer to the seller and are generally enforceable by the seller against the buyer. In most transactions, an acquisition is funded by a combination of debt finance and equity commitment – as such, the parties may include obligations on the buyer in the equity commitment letter, e.g., an undertaking that the buyer takes steps to ensure the advancement of debt finance.

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 highly uncommon 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 & Disclosure. A private equity seller in an IPO exit is responsible for ensuring, *inter alia*, that the prospectus for the offer of securities under the IPO contains all information that investors and their professional advisers would reasonably need to make an informed assessment of the rights and liabilities attaching to the securities. The Securities and Futures Act imposes criminal and civil liability for false or misleading statements in the prospectus.

Lock-ups. There may be applicable lock-up requirements under the listing rules of the SGX – please see question 7.2 below.

Interested Person Transactions. If the private equity seller retains a shareholding of 15% or more post-listing, it will be considered an "interested person" under the listing rules of the SGX. Transactions between the private equity seller (or its associates) and the company are considered "interested person transactions" and under the listing rules, the issuer may be required to make announcements of such transactions and to obtain prior shareholder approval.

Takeovers. As a private company will become a public company through the IPO, shareholders will be subject to the Takeover Code, which mandates that an offer be made, to all voting shareholders of the company, by any person who, together with persons acting in concert, 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 within any six-month period additional shares carrying more than 1% of the voting rights. These thresholds should be kept in mind by any private equity seller considering an IPO exit.

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

Moratorium requirements under the listing rules of the SGX apply in the following manner to private equity sellers:

- For those retaining a shareholding of 15% or more at the time of listing, the lock-up is for all their shares for a period of six months after listing, and potentially for an additional six months thereafter for at least 50% of the original shareholding, depending on the admission criteria that the company satisfies.
- For those retaining a shareholding of at least 5% but less than 15% at the time of listing, the lock-up is for the proportion of their shares representing a profit, acquired within the 12 months preceding the listing 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?

Private equity sellers only undertake dual-track exit processes when unsure of which option is more likely to be consummated. Sellers will end the dual-track process once it is clear that the preferred option is likely to come to fruition, and usually as soon as possible once it is clear. Recently, most dual-track deals have been realised through a sale compared to 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).

The most common source of debt financing used to fund private equity transactions is bank financing through loans. Occasionally, and in particular for larger transactions, a combination of senior debt, mezzanine debt and high-yield bonds may be used. The financing market in Singapore remains fairly stable. In comparison, the bond market tends to fluctuate and is therefore less commonly used than traditional bank 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?

A leveraged buyout involves acquiring a target company using a significant amount of debt financing. Such buyouts may involve a debt pushdown post-completion, whereby the target company assumes liability for the debt and grants a security over its assets to the lender. This arrangement constitutes giving financial assistance on the part of the target company, as the arrangement is for the purpose of or in connection with the acquisition of shares in itself. As such, if the target company is a public company or a subsidiary of a public company, the arrangement may have to first be whitewashed by its shareholders. Note that the restriction against giving such financial assistance does not apply if the target company is a private company, unless its holding company is a public company.

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

Singapore's debt market has been performing well, with bonds issued in 2019 amounting to more than S$95 billion, matching the record-high levels achieved in 2018. Further, in view of the increased interest in making environmentally friendly and socially responsible investments, Singapore's Monetary Authority of Singapore has launched the Sustainable Bond Grant Scheme to encourage such issuances, pursuant to which issuers can offset their external review expenses, subject to certain prerequisites.

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 investors should note that all income that is earned in or derived from Singapore, or that is derived outside Singapore but received in Singapore, is subject to income tax in Singapore. However, subject to meeting prescribed qualifying conditions, a Singapore tax resident will enjoy tax exemptions on the following types of foreign income that is remitted into Singapore: (i) foreign-sourced dividends; (ii) foreign-sourced profits; and (iii) foreign-sourced service income. The qualifying conditions that need to be satisfied include that: (i) the foreign income had been subject to tax in the foreign jurisdiction from which it was received; and (ii) the highest corporate tax rate of the foreign jurisdiction from which the income is received, at the time the foreign income is received in Singapore, is at least 15%.

Singapore does not have any capital gains tax. Further, Singapore practises a single-tier corporate income tax system, whereby the tax a Singapore resident company pays on its income is the final tax and shareholders will not be taxed on dividends.

Stamp duty of 0.2%, calculated based on the higher of the actual price or the value of the shares, is payable on a transfer of shares.

If a private equity acquisition is financed (wholly or partly) through debt, any interest, commission or fees in connection with the debt that is payable by a person in Singapore and to a non-Singapore resident company would be subject to withholding tax in Singapore. However, the applicable withholding tax rates may be reduced by tax treaties.

In relation to funds in particular, certain tax incentive schemes may be available for funds managed by Singapore-based fund managers. Specified income derived from a prescribed list of designated investments may be exempt from tax under the tax incentive schemes, subject to compliance with several conditions.

Off-shore structures are quite commonly used – please see the discussion in question 2.1 above for more details.

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 Singapore does not tax capital gains, one of the key considerations for private equity transactions is whether the gains from such a transaction constitute capital gains (which are not taxable) or gains of an income nature (which are taxable). The determination of whether a gain from disposal of shares capital or income is based on the relevant facts and circumstances in each case, and factors that will be considered to make this determination include the length of period of ownership of the shares disposed and the reasons for the disposal. Therefore, if a divesting entity is regarded as having acquired the shares to dispose them for a profit, the gains from a sale of shares will be treated as gains of an income nature, which are taxable.

Certain rules have been enacted in Singapore to provide a tax exemption for gains derived by a divesting entity from its disposal of shares that meet certain conditions. These conditions include that: (i) the shares disposed must be ordinary shares, and not any other type of shares; (ii) the divesting company had held at least 20% of the ordinary shares in the investee company for a continuous period of at least 24 months prior to the date of the disposal; and (iii) the disposal was made between 1 June 2012 and 31 December 2027 (both dates inclusive).

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?

Singapore does not have tax-efficient structures for rollover equity arrangements. However, share-based equity plans may be implemented, the gains from which are generally taxable.

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?

Under Section 13H of the Income Tax Act, authorised investments made by approved venture companies may be exempt from tax for up to a maximum of 15 years. This incentive scheme was initially scheduled to end on 31 March 2020 but, in order to promote the local fund management industry, was recently extended until 31 December 2025. The scheme accommodates Singapore limited partnerships and VCCs as well as companies (incorporated in Singapore or elsewhere).

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 2015, the Companies Act was amended to: (i) abolish the prohibition against financial assistance for private companies (unless its holding company is a public company); and (ii) introduce new exemptions to financial assistance for public companies. This facilitates leveraged buyouts involving private companies, as discussed at question 8.2 above.

Then, in 2017, the Companies Act was amended to introduce an inward re-domiciliation regime in Singapore, to enable foreign corporate entities to transfer its registration to Singapore and become a Singapore corporate entity.

Separately, a new Insolvency, Restructuring and Dissolution Act ("**IRDA**") came into force on 30 July 2020. A concept introduced under the IRDA is that of super-priority rescue financing – to qualify, the financing must either be necessary: (i) for the survival of the company as a going concern; or (ii) to achieve a more advantageous realisation of the assets of a company than on a winding-up. If the rescue financing satisfies, *inter alia*, either of the aforementioned requirements, the court may make orders that include that the debt can be secured by a security interest over property of the company that is already subject to an existing security interest, of the same priority as or a higher priority than that existing security interest. This concept of super-priority rescue financing therefore provides a new option for distressed M&A targets to consider.

As discussed at question 1.2 above, the VCC is a new corporate structure for investment funds, which took effect on 14 January 2020. The key features of a VCC include that: (i) it can be set up as a single fund or as an umbrella fund with sub-funds, each of which holds its own segregated portfolio of assets and liabilities; (ii) it can be used for both open-ended and closed-ended funds, the former of which is open to new subscriptions by new investors at any time while the latter is not; (iii) it must be managed by a qualified fund manager; and (iv) fund managers may re-domicile existing overseas funds to Singapore by transferring their registration to Singapore.

A highly anticipated legal development expected to take effect later this year is the SGX's introduction of regulations to allow the listing of Special purpose acquisition companies ("**SPACs**") on the SGX. SPACs are essentially shell companies that raise funds via IPOs in order to acquire targets, and have gained considerable traction in the USA. The SGX plans to allow SPACs to list on the Exchange, but with safeguards in place to sufficiently safeguard investors' interests. If SPACs are allowed to list on the SGX, it will certainly impact the structure of private equity transactions.

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

Generally, private equity investors are not subject to enhanced regulatory scrutiny, unless red flags such as money laundering, corruption and terrorism financing are raised.

One should note that while there are no general foreign investment restrictions in companies in Singapore, transfers of shares in companies operating in specific industries like broadcasting and newspaper companies are subject to foreign ownership restrictions.

Further, transfers of shares in companies operating in specified regulated sectors will be subject to regulatory approval – these include licensed banks and insurers, capital market services licence holders and designated telecommunications and electricity licensees.

Additionally, if an acquisition triggers competition concerns pursuant to the Competition Act, parties should notify the CCCS, to avoid the CCCS taking actions that include imposing financial penalties.

Lastly, takeovers and mergers involving listed companies should comply with the regulatory regime under the Takeover Code.

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 engage external legal counsel to conduct legal due diligence on the target prior to any acquisition.

While the exact timeframe for conducting legal due diligence varies, depending on the scope of due diligence involved and the availability of documents, it generally takes between one to two months. While the scope of legal due diligence varies, such scope minimally includes investigations as to the due incorporation of the target and the proper issuances of shares from incorporation as well as whether the target is involved in any litigious proceedings or investigations. The scope may also include a review of material agreements and banking facilities and advising if they contain, *inter alia*, change of control clauses, and other areas including a review of the target's existing intellectual property portfolio and its data protection policies.

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 anti-bribery and anti-corruption legislation is a precondition to private equity transactions in Singapore. If there is a risk of non-compliance with such legislation, investors will typically restructure the transaction to insulate from this risk.

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?

It is a fundamental principle of company law that a company is a separate legal entity from its shareholders, and therefore that: (i) a private equity investor will generally not be liable for liabilities of the underlying portfolio companies; and (ii) a portfolio company will generally not be liable for the liabilities of another portfolio company. However, if exceptional circumstances such as fraud exist, the Singapore courts may pierce the corporate veil and hold: (i) a private equity investor liable for the liabilities of the underlying portfolio companies; or (ii) a portfolio company liable for the liabilities of another portfolio company. Nevertheless, piercing the corporate veil is a last resort remedy that is only invoked when no other effective remedy can be achieved.

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, owing in part to its: (i) investor-friendly tax system – with its flat corporate tax rate of 17%, its extensive network of tax treaties and various tax exemptions and rebates available; and (ii) strong intellectual property regime that protects business interests, as a result of which Singapore has the highest number of registered patents in South-east Asia.

Singapore is consistently ranked as one of the simplest countries to do business, beating countries such as India, China and Korea. Our laws pertaining to private equity transactions are foreign investor-friendly, e.g., there are generally no foreign ownership restrictions for companies. Therefore, our laws should not cause too much concern on the part of experienced private equity investors.

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Yi Wayn regularly advises clients on cross-border acquisitions and disposals, investments, restructurings and equity capital market transactions in Asia, Europe, the United Kingdom and the United States. She advises on transactions of various sizes, from seed investments up to deals with a transactional value of approximately US$300 million.
She was a contributing author for the Lexis®Library's *International Corporate Procedures for Singapore* and assisted in the National University of Singapore, Faculty of Law's Corporate Deals programme. She has also spoken at accredited CPD workshops on "Advance Contract Law" and "Risk Mitigation and Allocation".
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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?

The South African market continues to see a substantial number of private equity (PE) transactions by local and foreign PE houses, including leveraged buyouts, public-to-privates, follow-on acquisitions, exits and Broad-Based Black Economic Empowerment (B-BBEE) transactions (see question 11.1 below).

The effects of the COVID-19 pandemic and its economic impact slowed or paused much deal activity in 2020 and have likely pushed out the holding period for many investments, although deal activity has begun to recover. Over recent years, 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 deployed, and similarly older fund vintages looking to realise assets should drive disposal activity.

1.2 What are the most significant factors currently 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 equity 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 that 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 are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

While the long-term effects of the COVID-19 pandemic remain to be seen, market movements have created opportunities for private equity players to delist JSE-listed companies in public-to-private transactions at reasonable valuations. Government intervention in and support for the South African economy following the COVID-19 pandemic has been relatively limited; however, developments in the regulations on electricity generation and further government bid programmes for generation will drive opportunities for infrastructure and other funds in the renewable energy and related sectors.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

We are seeing more corporate entities establishing special purpose investment vehicles (SPVs) that are structured as limited liability partnerships. We are also seeing more family offices investing in private equity funds as opposed to making direct investments themselves. The main consideration relates to checks and balances and special consent decisions to ensure that the investors are able to step in should the general partner not comply with their mandate.

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 the Newco, as well as a pledge over Bidco's shares in the 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). The use of debt push-down structures has become increasingly difficult to implement practically, given the possible disruption caused to the underlying business in having to transfer its assets to the Newco.

Subscription and buy-back structures have provided a tax-efficient exit for disposing shareholders (especially South African tax-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.

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 not be able to restructure into a new group to facilitate the debt push-down and 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 approach will evolve, 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 period). 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 that 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 carefully 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.

Importantly, encapsulating the good leaver or bad leaver mechanism for management may result in their return on an ultimate exit being recharacterised as taxable income and being taxed at the individual's marginal income tax rate (currently a maximum of 45%) as opposed to an effective capital gains tax rate of 18% (currently).

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 minority 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 therefore a public 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?

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 (which would include major asset disposals, schemes of arrangement and statutory mergers or amalgamations), 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 in 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 or arbitration, 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 in their capacity as employees, given public interest 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 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 common 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, foreign direct investment 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, which are licensed and/or have ownership requirements (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) a statutory 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 approval by special resolution (75% of votes exercised on the resolution) 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 a bank guarantee or cash confirmation is required at firm intention stage; and (iv) restrictions on the 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 (i) a private equity seller, and (ii) the 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.

Certain types of warranties, including anti-corruption, transfer pricing and product recall warranties, are generally 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.

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 buyer (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.

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 hang-over in the share price due to the additional shares that will be coming to market once the lock-up period expires.

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 portfolio company that 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, this is not common.

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 a common feature of PE transactions in the South African market.

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 lenders to provide financing to bridge or refinance fund investments.

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.

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% (currently) 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.

In certain instances, we also see notional vendor-funded arrangements that effectively rely on the underlying PE portfolio company to vendor fund management's participation through a loan type structure.

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 not have 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?

There is a continued focus by the South African Revenue Service on cross-border loan funding and transactions, and on ensuring that the interest deduction in the hands of the South African company is not considered excessive and that the transactions that are concluded are at arm's length.

South Africa is a signatory to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) (but has not yet deposited its instrument of ratification, acceptance or approval with the OECD). The MLI has introduced the concept of the "principal purpose test", which will look to deny any treaty benefits from applying where the principal purpose of a transaction is or was to obtain tax treaty benefits. This is particularly important to consider for non-resident investors looking to invest in South Africa.

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.

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 the Southern African Venture Capital and Private Equity Association (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) and tax due diligence, 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 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 that 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. Following amendments to the Competition Act, ownership by "historically disadvantaged persons" is also a public interest factor considered by the competition authorities in relation to merger approvals for transactions.

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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?

According to the Spanish Venture Capital & Private Equity Association ("*Asociación Española de Capital, Crecimiento e Inversión*", "ASCRI"), Spain has registered the third best historical year in terms of PE investment and number of transactions, despite being affected by the health crisis. Eight hundred-and-thirty-eight investments were executed (an increase of 10.3% with respect to 2019), beating a record in number of investments. Companies received EUR 6,275.2 million in equity, which represents a fall of 41.8% with respect to 2019, due to the decrease in transactions above the EUR 100 million in equity. Middle-market transactions (between EUR 10 million and EUR 100 million) marked a new record high for the second year in a row, representing 41% of the investments in PE in Spain channelled through 92 transactions, having represented 26% through 75 transactions in 2019. International management companies continue to be major market players accounting for 75% of the total investment volume and 192 transactions. However, Spanish investors, mainly family offices, have also played an important role. Spanish SMEs represent 90% of the companies invested.

On the divestment side, 302 transactions were closed, out of which, in terms of volume of investment, 55.8% were sales to third parties, followed by 17% for secondary buyouts, and 10.8% for IPO-related share sales.

The most active sectors in terms of PE transactions in 2020 were communications and IT, and life sciences reached a historical record. International investors maintained confidence in Spanish PE managers, mainly participating in middle-market deals.

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

Despite COVID-19's devastating effect in Q1 and Q2 2020, fundraising activity was restarted during the second half of the year, driven by the reopening of certain economic sectors as well as by the usual factors that previously drove PE investments in Spain, that is, amongst others: (i) existence of liquidity in the markets and available dry powder; (ii) low interest rates; (iii) existence of global deals with cross-border impact; (iv) transactions implemented using hybrid instruments such as convertible/mezzanine debt provided by specialised funds; and (v) easy access to financing (banking debt and direct lending), including the availability of grants and subsidies from the public sector.

Likewise, several factors are having an adverse effect on the PE transactional market: (i) the costs in the investee portfolio of coping with the COVID-19 pandemic; (ii) an increase of PE funds' average waiting time for divestitures; (iii) penalties imposed on valuations and general market uncertainty; and (iv) the general lack of certainty on the full recovery dates at global markets.

From a strictly legal standpoint and as in most European Union Member States, the restrictions and control over essential freedoms, such as the freedom of movement of capitals and the limitations on foreign investments imposed in Spain have substantially impacted the way and timing of closing transactions. Pursuant to this: (1) certain investments from foreign-controlled PE funds; and (2) exit strategies to certain third party acquirers may need to complete a prior authorisation process. To respond to the current COVID-19 situation, the Spanish Government passed a new regulation, which suspended the general deregulation approach Spain enjoyed. Since 2020, certain "Foreign Direct Investments" ("FDI") made: (a) in specific "Strategic Sectors" of the Spanish economy affecting the national security, public policy and public health; and (b) by certain foreign investors that meet certain subjective conditions, as further explained in question 4.1 below, may require the prior authorisation of the Spanish Council of Ministers.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

One of the long-term effects relates to valuations. It is very likely that, except for a few very specific sectors, valuations (i.e. EBITDA multipliers) may drop. Another effect may relate to greater competition for fewer or smaller transactions, which may lead to an inflation in pricing. In the last wave(s) of COVID-19, the shrinking of the Spanish market has already been visible, traditionally larger funds are setting up vehicles to compete in the middle market, and middle market funds are getting access to larger transactions than traditionally.

In addition, the Spanish legislative action in 2020 (through the passing of the State of Alarm ("*Estado de Alarma*") legislation and the different regulations and subsequent amendments passed by the Spanish Government in relation to said State of Alarm) impacted several economic sectors and the general economic activity. Those sectors hit the most by the State of Alarm regulations, such as general travel, tourism, hotels, retail and transportation, will take longer to recover.

However, certain government intervention had – and still has – a positive impact on investments. Regulation such as: (i) the issuance by the Spanish Official Credit Institute ("ICO") of a debt and bond programme (bank guarantee lines) for Spanish entities; (ii) the implementation of furlough schemes ("ERTEs"); (iii) the application of tax flexibility measures; (iv) the adoption of rent and mortgage moratoriums; and, amongst others, (v) the possibility of holding corporate board meetings remotely, is providing oxygen to Spanish SMEs and some large corporates.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

Without representing a consistent trend, a few family offices or structures managing the capital of third parties as well as other funds, which in the past focused more on mezzanine financing or opportunistic transactions, are now engaging more in traditional PE.

In addition, some large industrial companies are investing in companies that develop new technologies linked to their core business. Some differences between those kinds of transactions and traditional PE deals are: (i) more flexibility in the exit horizon; (ii) the investment is sometimes driven by the access to the information and/or technology, instead of pure financial return; and (iii) more difficulties in terms of corporate governance, remuneration/ratchets of the management team and willingness to retain access to the developed technology after exit.

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: (i) acquisition of companies in which a part of the purchase price is financed (leveraged buyouts, or "LBOs"); (ii) financing of the growth of companies that are certainly consolidated or already have profits; (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 certain troubled companies.

Transactions may be executed by regulated funds ("*entidades de capital riesgo*") through direct investment in the target companies or through holding vehicles ("BidCos") whose shareholders are the PE funds, jointly with its shareholders and the fund management team, when applicable. BidCos are the acquiring entities and often also act as borrowers when acquisition financing is needed.

Transaction structures for foreign PE investments focus, in general, on certain tax aspects (mainly the tax treatment of dividends and capital gains at the exit). International PE companies sometimes channel the investment through Spanish companies subject to the ETVE regime ("*entidad tenedora de valores extranjeros*") 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 the European Union 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 essentially relate to: (i) financial considerations and the ability to grant sufficient warranties to the financial entities; and (ii) tax reasons, not only looking for tax-efficiencies but also due to the requirements imposed by the country of origin or by Spanish tax regulations for tax deductibility.

Other drivers are: (a) the expected returns for the investor; (b) the role and incentives of the management team and PE sponsors; (c) the economic and operational costs related to the post-closing restructuring of the company; and (d) the rules and costs of exit.

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 BidCos.

The investment of the management team is often financed (partially) through loans that can be provided by PE sponsors and are repayable 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. 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. The 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 (typically four to five years) 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 all the 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 until that moment, and then the amounts are distributed equally to both investors and management, *pro rata*, until that 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 unless they entail control.

In Spain, PE funds usually acquire majority stakes, unless 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 or managing bodies, exit provisions (including tag-along rights, put options, etc.) and key management retention or exit schemes, amongst 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?

Management teams usually take 5–10% of the share capital of BidCo or 15–20% in secondary PE deals.

Vesting provisions for ratchets and other 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 provisions (see question 2.6 below) 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 (and usually also the other shareholders) to purchase the equity that a manager leaving the company held at a pre-agreed purchase price. Share transfer conditions usually vary depending on whether it is a good leaver (where it is sometimes allowed that the leaving manager keeps the shares) or bad leaver situation.

Call options may also be granted to ensure effectiveness of the transfer obligation, 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 cessation of a management equity holder for a reason they cannot control, such as: (i) death; (ii) retirement; (iii) permanent illness or physical disability that 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 may be granted the right to 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 that both good and bad leavers may be obliged to transfer their shares. Thereupon, it is common to include a clause in the by-laws 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 of the board of directors of their portfolio companies, even when their representation in the board is higher than in the share capital. They control the decision-making process and are involved with the company's business and day-to-day operations. 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.

PE investors can usually impose super-majority voting requirements for the passing of certain key decisions of the company, both in general shareholders' meetings and board of directors' meetings, as well as impose 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 and role of the management group, the limitation to the powers of attorney of 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?

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), 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 by-laws 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?

The Spanish Capital Companies Act ("LSC") sets forth some binding minimum and maximum majorities to decide on certain matters (such as the removal of directors, amendment of the company's by-laws or corporate restructurings, to name a few) 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 may not be included in the by-laws of the company or registered and, therefore, they become private agreements amongst the shareholders enforceable amongst them but not against any third parties.

Likewise, the requirement of the unanimous favourable vote for the adoption of certain matters at the board of directors' level can be included in the shareholders' agreement but not in the by-laws, as such provisions are rendered void and, therefore, not enforceable.

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 may be challenged when they are contrary to the Law, the by-laws or the company's meeting regulation, or damage the interest of the company to the benefit of one or more shareholders 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 (that is, 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 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)?

Shareholder agreements are private and only enforceable against the parties who have signed them, while by-laws and other corporate documents are public and thus enforceable against not only the company and its shareholders but also against 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, diligence, loyalty, avoiding conflict of interest situations and secrecy. Directors are held personally accountable for any damage caused by their acts performed without diligence or against the law or the company's by-laws. 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 by-laws, 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 are 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 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 place 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, foreign direct investment 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 the European Union, national or local levels depending on the applicable regulation.

In addition, as explained above, the new article 7-*bis* of Spanish Law 19/2003, of July 4, subjects FDI in strategic sectors (critical physical or virtual infrastructures, critical technology and dual-use items, essential commodities, in particular, energy, sectors with access to sensitive data and media), made by residents (or which beneficial owner is resident) of countries outside the European Union and the EFTA, to prior administrative authorisation by the Spanish Government (Council of Ministers) if, as a consequence of such investments, the investor holds a stake equal to or greater than 10% of the capital stock of the Spanish company or effectively participates in the management of the Spanish company or in its control.

As of March 18, 2020, FDI is also restricted (and may be subject to prior authorisation) to foreign investors that are directly or indirectly controlled by a third-country government (including public agencies, the military or armed forces), amongst others. This subjective condition may impact sovereign wealth and certain pension funds and other institutional investors who are natural investors in PE funds.

Finally, authorisations are also required for those acquisitions that result in a business concentration that exceeds certain antitrust thresholds (supervised by both Spanish and European Union competition authorities).

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

In recent years, auctions and IPOs 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.

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 that 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 costs. 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 proper buyer protection under this structure, the seller will have to warrant the non-existence of undisclosed leakage 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. Most of the time, earn-outs are conflictive and easily lead to arbitration/litigation.

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

PE sellers commonly have to offer a set of representations about the target company, although the scope and time are limited. Escrow deposits are still 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. Escrow deposits are used much more frequently than price retentions, set-offs or on-demand bank guarantees.

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 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 generally 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, and affects both PE and regular M&A.

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 are usually agreed between the parties.

Warranties in PE transactions are rarely granted, except where the management team are also selling shareholders.

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 buyer (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 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 precedent, 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?

Lock-ups 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, 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).

The most common source of debt is bank financing. However, alternative financing tools have arisen, especially since the last global crisis where banks were not providing liquidity enough, such as in direct lending (vendor's loans or direct financing at the target company) and financing obtained from some mezzanine debt funds.

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.

Although the COVID-19 pandemic affected the high-yield bond market, recovery is forecasted for 2021, with attractive yields and low-risk premiums.

Despite the high dependence on financing from traditional banks, the trend for Spanish corporates is to actively source alternative financing. This trend might be reinforced in post-COVID-19 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?

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, despite the fact that financial entities and banks are offering liquidity and lower interest rates, in recent years the Spanish market, driven by a macroeconomic positive environment and a record of PE transactions, 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 dividends and capital gains derived from the transfer of shares in the Spanish PE) is not usually 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 the beneficial owner of the interest and they are a European Union 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 for international Funds. 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. A 95% participation exemption regime (a 100% participation exemption until 2020) 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 95% exempt.

The standard CIT rate is 25%, so this new 95% participation exemption leads to an effective 1.25% (25% × 5%) taxation on qualifying dividends and 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)?

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 a maximum 26% Personal Income Tax rate (depending on the Autonomous Community), which is lower than the taxation of the income received as employment remuneration (which, depending on the Autonomous Community, may reach a 50% marginal rate). 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, amendments have been introduced in the relevant applicable regulations in the territories of the Basque Country and Navarra 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 European Union 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 26% 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 shares' 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?

The last legal reform operated in the tax area with a significant impact in the PE industry and structures was carried out in 2014, with effects as of January 1, 2015 (mainly due to the amendments on interest deductibility and tax consolidation). As explained in question 9.2 above, recently, the territories subject to Foral and special tax regimes (Basque Country and Navarra) have enacted certain regulations on carried interest. In 2020, a new reform, effective as of January 1, 2021 has brought certain additional tax reforms that may have an impact on the traditional PE structures, such as the reduction to 95% of the participation exemption on dividends and capital gains.

As to the approach of the tax authorities, interest deduction in PE structure has been the main area of discussion over the last few years (especially, in intra-group indebtedness), together with the analysis of the rationale and substance of structures as a whole (following OECD/BEPS approach). This has been reinforced with the implementation into Spanish regulations of the provisions of ATAD 2 Directive, covering all the types of hybrid situations and hybrid mismatches.

Tax rulings aimed at protecting particular situations or transactions may be more difficult to obtain, as the Directorate General of Taxes is focusing on the technical interpretation of the rules, rather than on its application to particular transactions.

Furthermore, there is recent ECJ case-law (known as the Danish cases) and domestic case-law, where the Danish cases have already been transferred to the Spanish context, which refers to the "beneficial ownership" clause as an autonomous anti-abuse provision, potentially leading to the denial of the benefits of the European Union Directives in terms of exemption on withholding taxes on dividends and interest paid to European Union residents.

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?

No significant new legislation affecting PE investments was enacted or amended in 2020, except for: (i) the amendment of the Spanish Securities Market Act ("LMV") 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 the management companies and impose additional requirements, especially in the commercialisation of funds; and (ii) the legal extraordinary regulations approved within the frame of COVID-19, as mentioned in section 1 above, particularly these affecting FDI authorisation.

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

PE transactions are not subject to any prior authorisation unless, as stated in question 4.1 above, the company is engaged in a regulated sector, the transaction results in a concentration of companies that exceeds certain antitrust thresholds, or the transaction requires prior FDI authorisation.

Further, any foreign investments or divestments in Spanish companies (no matter who the final foreign investor is) must, however, be communicated to Spanish authorities once executed, for statistical purposes only.

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 investment from several perspectives, including legal, financial and commercial, tax, technical, regulatory and compliance. However, red-flag reports, sample-based due diligence and materiality thresholds are common as well. The scope and detail of the analysis are also adjusted depending on the insurance requirements and limitations of coverage.

It is generally conducted by outside advisors specialised in each area. The usual timeframe covers between two to four weeks, depending on the information available, the commitment, the resources devoted by each party and the technology used in the process.

Publicly traded companies are normally exempt from 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 focusing on compliance and anti-corruption/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 common 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?

A PE investor may be held accountable for the liabilities of the underlying portfolio companies: (i) if the PE investor is considered 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, a portfolio company (or 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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Garrigues is a leading legal and tax services firm with international coverage through our dedicated offices in Beijing, Brussels, Bogota, Casablanca, Lima, Lisbon, London, Mexico D.F., New York, Porto, Santiago de Chile, São Paulo, Shanghai, and Warsaw, in addition to our 18 offices in Spain.

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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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?

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. Almost half of the total deal volume and half of the top 50 deals in 2020 involved private equity firms (according to the KPMG M&A Report 2020 for Switzerland).

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

Low interest rates for transaction financing, as well as favourable borrowing conditions, still generate an incentive for private equity activity. While deal activity in 2020 has been overshadowed by the COVID-19 pandemic, deal flow in 2021 so far suggests a quick recovery (see question 1.3).

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

It is our expectation that the COVID-19 pandemic will not slow down private equity deal-making over a longer period. Companies receiving government funding due to the pandemic have to comply with certain restrictions, e.g. they may not disburse dividends for a certain period. Such restrictions (to upstreaming cash) have to be taken into account when structuring private equity transactions.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

A number of family offices are playing an active role in Swiss private equity-style transactions, both in co-investments with private equity funds and as sole investors. In particular, in the latter case, their approach can differ from traditional private equity firms, e.g. in terms of structuring in connection with tax considerations.

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, the 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, etc.).

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-along and tag-along 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.

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 that 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 that 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.

In June 2020, the Swiss federal parliament approved a general corporate law reform. The aim of the reform is to modernise corporate governance by strengthening (minority) shareholder rights and, for listed companies, promoting gender equality in boards of directors and in senior management. Furthermore, the new law will facilitate company formation, makes capital rules more flexible (e.g. allows for capital to be denominated in a foreign currency) and amends the rules on corporate restructurings. The amendment is expected to enter into force at the start of 2023.

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, provided 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 are:

- an 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.

An 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 an 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.

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, foreign direct investment 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. There is no general approval requirement regarding foreign direct investments, however.

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 has been easily available, buyers became more willing to enter into binding purchase agreements prior to securing financing.

Further, given the recent sellers' market, share purchase agreements had tended to be more seller-friendly (e.g. with regard to R&W, etc.), albeit not as extreme as in the preceding years.

It is too early to determine whether these trends will be affected by the COVID-19 pandemic.

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 that, when added to equity securities already owned, exceed the threshold of one-third of the voting rights (irrespective of whether these voting rights are exercisable) 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 such threshold in its articles of association 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 triggering 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), respective 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.

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 have been seen less often recently.

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

Usually, a customary set of representations and warranties is granted by a private equity seller and co-selling managers, which is not materially different from what strategic sellers offer. Quite often, tax indemnities are seen.

If W&I insurance is taken out, claims can only be brought against the latter.

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?

W&I insurance has become quite common in Switzerland.

Usually, 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 buyer (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 six to 18 months after the IPO. Therefore, SHAs among private equity investors and agreements with directors and managers should provide for respective undertakings.
- Drag-along rights: SHAs should also include drag-along 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 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 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, a trade sale (auction) process will often just take 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 relatively 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 and cross-stream 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?

Certain limitations on leverage 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 applies if debt is provided by a third party but secured by a shareholder. 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.

Furthermore, there are restrictions on Swiss companies granting loans or providing security that are of an upstream or cross-stream nature (see question 8.1 above).

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

M&A activities remained a driver for debt-financing transactions, although the deal values were generally lower than in previous years.

2021 also continues to be driven by the COVID-19 pandemic and a state-backed credit support programme for Swiss companies. In order to fight the financial consequences of the COVID-19 pandemic for small and medium-sized businesses, such businesses may request from Swiss commercial banks emergency credit lines that are guaranteed by the Swiss government. Due to the restrictive covenants of these emergency credit lines (*inter alia*, a dividend prohibition on a single entity level), an acquirer will need to refinance these emergency credit lines with priority.

Furthermore, the Swiss debt-financing market is still shaped by negative interest rates introduced by the Swiss National Banks and market participants are kept busy by the change from LIBOR to other base interest rates.

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 withholding tax (*Verrechnungssteuer*) and securities transfer tax (*Umsatzabgabe*) regimes. Therefore, private equity funds are typically 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 (generally a minimum of 10% shareholding) dividend distribution from a Swiss company. The entitlement for a withholding tax reduction requires sufficient substance and beneficial ownership of the shareholder in the Swiss target.

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 capital gain on the sale of shares that have been acquired at fair market value ("FMV") by a Swiss resident manager will generally qualify for a tax exemption. However, the determination of FMV is often difficult for non-listed shares and as fall-back, a formula value can be applied. There are no specific tax reliefs or tax provisions for management share participations, except for blocking period discounts (6% per blocking year for a blocking period of up to 10 years with a maximum discount of 44.161%) if shares are acquired below FMV. The taxable income is calculated as the difference between the (reduced) FMV of the shares and the price at which they are sold to the employee (if the latter is lower).

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 or as taxable salary 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 manager as well as the Swiss employer (as well as wage withholding tax, if applicable). Thus, it is recommendable to confirm the consequences of a specific management participation in an advance tax ruling (Swiss social security authorities generally follow the Swiss employment income tax treatment).

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 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, however, not change the currently applied practice.

Further, the Federal Act on Tax Reform and AHV Financing (approved in a referendum on 19 May 2019) entered into force on 1 January 2020 and provides for an abolishment of the privileged tax regimes. It also has an impact on the effective tax rates of Swiss target companies, as, in order to maintain attractive tax conditions for investors in Switzerland, measures such as a reduction of corporate tax rates, a lower taxation of profits from patents and similar rights ("patent box"), an additional R&D deduction, a notional interest deduction on above-average equity (currently only enabled in the canton of Zurich) and exemptions for capital tax purposes were introduced. The tax reform also provides for an immigration step-up, i.e. legal corporations that relocate their headquarters to Switzerland may disclose hidden reserves, including goodwill, in a tax-neutral way and subsequently create tax-deductible expenses through amortisation of the stepped-up value (inversely, if such companies migrate from Switzerland abroad, an exit tax on hidden reserves will be due, as has already been the case prior to the reform. Further, the lump-sum tax credit system was adjusted and now allows lump-sum tax credits for Swiss permanent establishments of foreign corporations under certain circumstances. Finally, adjustments with respect to dividend taxation for individuals were introduced, setting dividend inclusion for individuals owning corporate equity stakes at 70% at federal level and at least 50% at cantonal level (cantons may raise the inclusion ratio even further, which to date led to range between 50% and 80% amongst the cantons).

Finally, Swiss 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 similar payments by related parties (instead of by the target company itself) could qualify as (taxable) salary, which is generally subject to social security contributions on the level of the employee and the Swiss employer as well as wage withholding tax, if applicable.

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 mentioned, in June 2020, the Swiss federal parliament approved a general corporate law reform. The reform also introduces certain disclosure requirements for commodity firms. In addition, existing provisions on excessive compensation for listed companies will be moved from a separate ordinance into the Swiss Code of Obligations. Certain parts of the reform, in particular the provisions on gender equality and transparency rules in the commodities sector, have already been in force since the beginning of the year. The rest of the reform is expected to enter into force in 2022. In addition, on 1 January 2021, a revised Commercial Register Ordinance entered into force, modernising the rules governing the Swiss commercial registers.

Another notable change in Swiss corporate law was implemented in November 2019 and concerns the regime for the notification of the beneficial owner of shareholders acquiring more than 25% in a Swiss company. Failure to comply with the obligations to disclose the beneficial owners to the company is subject to a fine, as are intentional breaches of directors' obligations relating to the keeping of a share register and register of beneficial owners. These criminal sanctions apply in addition to corporate law consequences of non-compliance with disclosure duties, which include the suspension of voting rights and the loss of property rights (e.g. the right to participate in dividend distributions) until due notice is given to the company by the relevant shareholder. Another key pillar of the amended rules is the *de facto* abolition of bearer shares. Subject to few exceptions (notably companies with shares listed on a stock exchange), Swiss stock corporations are no longer allowed to issue bearer shares. Existing bearer shares had to be converted into registered shares by 30 April 2021. Bearer shares that were still outstanding in May 2021 were converted by the competent authorities.

On 1 January 2020, the Financial Services Act (FinSA) and Financial Institutions Act (FinIA) entered into force, changing the Swiss financial regulatory landscape significantly. The FinSA, in particular, introduced new concepts of financial services regulation, partly modelled on the MiFID, to Switzerland. Furthermore, in this context, a number of revisions were made to the Collective Investment Schemes Act (CISA), which have affected the regulatory framework for the offering of interests in private equity funds and other investment funds in or into Switzerland. The revised regime is subject to transitional rules under which most of the new regulatory duties are phased in over a period of up to two years, ending in December 2022.

In a nutshell, the revision of the CISA abolished the former concept under which both product-related requirements and point-of-sale duties in connection with investment funds were linked to a broad notion of "distribution" with very limited exceptions, limiting the possibilities of foreign private equity funds to raise funds in Switzerland without triggering regulatory requirements. The new regime is more closely integrated with general financial instruments regulations and enables the offering of foreign investment funds to a broader audience of qualified investors (including, for instance, regulated financial institutions, but also large corporates, occupational pension schemes and other companies with professional treasury operations) without having to seek approval of the fund by the Swiss regulator FINMA and/or having to appoint a Swiss paying agent and representative. Furthermore, the licence/supervision requirement for distributors of collective investment schemes was abolished with the revised CISA. However, activities in or into Switzerland, aimed at the purchase of fund interests by Swiss investors, may qualify as a "financial service", which may trigger point-of-sale duties and other requirements under the FinSA, even if conducted on a cross-border basis from abroad.

In August 2020, the Swiss Federal Council has adopted the dispatch on amending the CISA. By exempting certain collective investment schemes from the requirement to obtain authorisation and approval from the supervisory authority (FINMA), the amendment aims at creating a new fund category in Switzerland that offers qualified investors an alternative to similar foreign products. This should increase Switzerland's competitiveness as a fund location in the future. The bill is currently being discussed by Swiss parliament and is not expected to come into force before 2022.

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, at this point there are no political majorities 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, data protection 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 as well as transaction agreements, 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 CC 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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Luca Jagmetti has several speaking engagements on asset transactions, legal DD and other M&A topics (e.g. a Course on Commercial Law of the University of St. Gallen; an LL.M. programme at the University of Zurich).
According to *The Legal 500* (2016), he is "very knowledgeable and speedy". *IFLR* (2020) lists him as highly regarded.

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Bär & Karrer is a leading Swiss law firm with more than 170 lawyers in Zurich, Geneva, Lugano and Zug. The core business is advising clients on innovative and complex transactions and representing them in litigation, arbitration and regulatory proceedings. The clients range from multinational corporations to private individuals in Switzerland and around the world. Bär & Karrer was repeatedly awarded "Switzerland Law Firm of the Year" by the most important international legal ranking agencies in recent years. Almost all leading private equity funds active in Switzerland form part of our client basis.

- 2019 STEP Awards ("International Legal Team of the Year").
- 2019 *Citywealth* Magic Circle Awards ("Law Firm of the Year – Switzerland").
- 2019 *International Financial Law Review* (*IFLR*) Awards ("Debt and Equity-linked Deal of the Year").
- 2019, 2015 and 2014 *IFLR* Awards ("Legal Adviser of the Year – Switzerland").
- 2018 *IFLR* Awards ("Deal of the Year").
- 2020, 2019, 2018, 2017 and 2016 Trophées du Droit Gold or Silver.
- 2019, 2018, 2016, 2015 and 2014 *Mergermarket* M&A Awards.
- 2016, 2013 and 2012 *Chambers* European Awards ("Switzerland Law Firm of the Year").
- 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?

In local practice, recently the most common types of private equity ("PE") transactions have been related to technology, media and telecommunications ("TMT") industries, while some traditional industries such as the chemical industry and people's livelihood consumption enterprises have also been increasingly favoured by large international PE investors. Recently, a series of significant deals led by PE funds were completed, including Magicapital's take-private acquisition of On-Bright and Ili Technology, KHL Capital's investment into telecom service provider Taiwan Star, and AMP Capital's investment into offshore wind farm pioneer Swancor.

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

Factors encouraging PE transactions normally include, for example: (i) from the perspective of a portfolio company, the need to re-structure the company from a financial and/or operational viewpoint with the assistance of PE firms; and (ii) from the perspective of PE firms, the potential increase of value of the portfolio company if the company is benefitted from the resources (strategically or otherwise) that can be brought into the company by PE firms.

With respect to inhibitory factors, the attitude of the government would be the main factor affecting PE transactions. For example, the government might not necessarily wish to see large or reputable companies delisted from the exchanges in Taiwan. Also, the government would be concerned about the protection of minority shareholders under a take-private transaction. In addition, some government officials seem to still hold a rather conservative view towards PE firms and transactions, thinking that PE firms focus more on relatively short-term investment performance and would not necessarily be good for local stakeholders (e.g., industries, employees, etc.).

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

Given the uncertainty surrounding the COVID-19 pandemic, it is difficult to gauge the longer-term impact on industry performance. Therefore, we expect that PE firms will be more conservative towards the economic outlook and cherry-pick the underlying companies/industries or even halt transactions. However, we believe that there will still be PE firms that wish to proceed with transactions under which the target is undervalued, or even financially distressed, but with large potential to recover due to, for example, its core technologies or competitive edge among the industries. To our knowledge, although several relief and economic stimulus packages have been proposed or implemented by government authorities, they are generally aimed to provide financial assistance to enterprises that were severely affected by the outbreak of COVID-19, without specifically addressing any issues that may be faced by PE or PE activities.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

No, not to our knowledge. In local practice, traditional PE firms are still the most common investors executing PE-style transactions in Taiwan.

2 Structuring Matters

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

In local practice, it is very common to see a PE firm establishing a local special purpose vehicle ("SPV") to acquire the shares of the portfolio company in Taiwan.

Additionally, for a public transaction under which the PE investor wishes to acquire 100% of the shares of the Taiwan company, the following two approaches are commonly considered and adopted:

(i) two-step approach: the PE investor firstly launches a tender offer to acquire more shares of the target company, followed by a share swap to acquire the remaining shares; and
(ii) one-step approach: the PE investor carries out a share swap to acquire the shares of the target company directly.

2.2 What are the main drivers for these acquisition structures?

The main reasons for setting up a local SPV for acquisition (as indicated under question 2.1 above) are tax efficiency and simplicity in transaction structure and related actions.

With respect to approaches (i) and (ii) as described in question 2.1, a PE investor may tend to adopt approach (i) (i.e., launching a tender offer first to acquire more shares of the company) if it cannot be certain whether the proposed M&A will be passed by the shareholders' meeting.

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

In Taiwan, the equity structure for PE transactions should vary from case to case, and there is no typical way of equity structuring in PE transactions.

While the arrangement of original major shareholder/management rollover is increasingly popular in Taiwan, it is commonly arranged that the rollover participants hold the equity of an offshore entity upon closing of the PE transactions.

Similar to many other jurisdictions, carried interest is the principal part of the compensation to the general partner ("GP") of a PE fund.

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

In local practice, it is rare for a PE investor to take a minority position. If a PE investor is taking a minority position in a portfolio company, it is anticipated that the minority PE investor would wish to include clauses that may protect the interest of the minority shareholders, such as tag-along rights, right of first refusal, and even veto rights for certain matters. A minority PE shareholder may also wish to have one or more board seats, depending on the percentage of shareholding, in order to have the information rights that entitle a director.

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 Taiwan, the range of equity allocated to the management varies from case to case, and there is no typical range in this regard. According to our experience, the management may be entitled to equity pursuant to an employee stock ownership plan ("ESOP") or similar arrangement under which a certain portion of equity vests after a certain period of time and/or is based on performance of the target company. It is also common that PE or the target company may have the right to purchase the equity held by the management at a certain price in case of their departure.

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

Whether a management equity holder is treated as a good leaver or bad leaver varies depending on individual circumstances. Generally speaking, a PE firm would tend to treat a management equity holder as a "good leaver" if the leaver's conduct is without fault (e.g., death, disability, retirement), and as a "bad leaver" if there is, to some extent, fault on behalf of the leaver (e.g., dismissal for cause, breach of the shareholders' agreement, failure to achieve certain targets or expectations, etc.).

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 no typical governance arrangements for a PE portfolio company if the PE investor acquires 100% of the shares of such portfolio company.

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 the PE investor acquires 100% of the shares of the portfolio company, the portfolio company will be wholly controlled by the PE investor, so there should be no issue regarding veto rights.

In case a PE investor takes a minority position, the PE investor may wish to have veto rights over activities that will materially affect the company, such as M&A, issuance of securities, change to the business plan of the company, material transactions and capital expenditure, etc. The veto rights may be entitled to the PE investor at the level of shareholders' meeting or, in case the PE investor nominated any director of the company, the board meeting.

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?

From a contract point of view, there is no limitation on the effectiveness of veto arrangements under Taiwan law, and if a party is in breach of the veto arrangement, the other party may seek remedies against the breaching party under the contract. If the contract also stipulates that the veto arrangement should be reflected in the constitutional document (i.e., articles of incorporation ("AOI")) of the company, not all of the thresholds expressly specified in the Taiwan Company Act for the resolutions of shareholders and directors may be raised by the AOI. Therefore, any attempt to reflect the veto arrangement in the AOI that contradicts the statutory voting thresholds may be deemed null and void.

Also, the Taiwan Company Act permits shareholders of non-public companies to have contractual voting arrangements. Therefore, the enforceability of voting arrangements among shareholders of a public company might not necessarily be recognised by the court.

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 local law and practice, there are no specific duties owed by a PE investor to minority shareholders, except where the PE investor appoints any directors in the company, in which case such directors shall have fiduciary duties under the Taiwan Company Act.

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)?

From a Taiwan legal perspective, choice of foreign law (governing law) and submission to exclusive jurisdiction of a foreign country (jurisdiction) will be recognised and given effect by the courts of Taiwan, provided that Taiwan courts may refuse to apply the relevant provisions of foreign law to the extent such courts hold that: (i) the application of such provisions would be contrary to the public order or good morals of Taiwan; and (ii) such provisions would have the effect of circumventing mandatory and/or prohibitive provisions of Taiwan law. For submission to an exclusive jurisdiction of a foreign country, a submission to jurisdiction clause and the relevant foreign court judgment would be generally recognised and enforced by Taiwan courts on a reciprocal basis.

The obligations of shareholders under non-compete and non-solicit provisions are generally recognised by the courts. However, if a shareholder is an executive officer of the target company and his shareholding is limited, his non-compete obligations after termination of service agreement may be subject to the court's review (and the important factors that may affect the validity of such non-compete obligations include proper consideration and period, etc.).

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 legal restrictions or other requirements with respect to a PE investor's appointment of any directors in portfolio companies, except that such directors shall have fiduciary duties under the Taiwan Company Act, which include the duty of loyalty to the company. Also, from a Taiwan law perspective, the individual(s) appointed by a PE investor to act as the director(s), and the PE investor itself, would be deemed director(s) of the target company for all purposes of the director's fiduciary duties. Therefore, if any individual appointed by a PE investor to act as the director breaches his fiduciary duties and causes damage to the target company, the individual and the PE investor may be jointly and severally liable for such damage.

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?

Theoretically speaking, directors nominated by a PE investor are subject to their fiduciary duties to the target company. However, in local practice, the risk of conflict of interest may be remote. First of all, as PE investors normally acquire 100% equity of a target company, the best interest of the company is usually aligned with that of the PE investor. Also, where the target company has more than one shareholder (e.g., PE investor and rollover participants), the governance of the target company would be carried out in accordance with the shareholders' agreement, and the decision made in the board meeting should be a result that reflects the principles and voting arrangements agreed by all shareholders in the shareholders' agreement.

4 Transaction Terms: General

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

In Taiwan, PE acquisitions are often subject to foreign investment approvals and an antitrust review process. For those target companies that are in a regulated industry, approval from the competent authority would also be required. Therefore, whether and how regulatory approvals can be smoothly obtained is a critical issue to the completion of a PE transaction in Taiwan, which would materially impact the timetable for PE transactions in Taiwan.

Disclosure obligations and financing are normally not major issues impacting the timetable for transactions in Taiwan.

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

Acquisition by PE investors has risen strongly in recent years. The major reasons include the local regulators' policies (being neutral to such transactions), the relatively low price-to-earnings ratio of Taiwan listed companies, and favourable interest rates in local financing markets. Also, use of warranty and indemnity ("W&I") insurance has become more common in local M&A transactions, especially for take-private transactions by PE 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?

With respect to a public-to-private transaction where the target company will be delisted, a particular challenge is the regulatory threshold of shareholders' resolution. Where the target company is to be delisted upon closing, such transaction would require approval of two-thirds of the total number of the issued shares of the target company. It is noteworthy that the government has even proposed to raise the threshold from the current two-thirds to three-quarters, although this proposal is still under discussion. The common way to deal with this challenge is by (1) first launching a tender offer to acquire more shares before carrying out the M&A requiring such a high threshold, and/or (2) entering into an agreement with existing major shareholder(s) who could help obtain a sufficient number of votes to support the proposed transactions.

We do not see any particular challenges with respect to the financing of PE investors in public-to-private transactions.

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

Under public acquisitions, it is common to see a PE investor request the seller to accept an exclusivity provision, under which the seller may not look for other buyers after the signing of the definitive agreement.

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 local practice, PE investors typically prefer to use cash consideration for private acquisitions on both the sell-side and the buy-side.

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

Typically, the package of warranties offered by the PE seller in a private acquisition is similar to those customarily provided by the sellers in normal M&A transactions. With respect to indemnities, a PE seller would normally tend not to offer a long period during which the buyer may seek for indemnities; otherwise the PE firms may not be able to have a clear exit or make the distribution to its investors soon after the closing of the transactions. We notice that in some cases, W&I insurance was used to bridge the gap.

In local practice, it is not typical to have warranties/indemnities separately offered by the management team to a buyer under private acquisitions.

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?

In local practice, other than certain typical pre-closing covenants such as "standstill", a PE seller normally would not agree to provide post-closing covenants for non-competition, etc. With respect to indemnities, as advised under question 6.2, normally a PE seller would tend not to offer a long period during which the buyer may seek for indemnities.

In local practice, management teams who are also selling shareholders would be required to either enter into a certain retention arrangement or undertake not to compete with the target company for a certain period of time after the 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?

In local practice, W&I insurance has recently become increasingly popular. Our observation is that the buyer may consider obtaining W&I insurance when a seller needs a clear exit (such as a PE seller) or the nature of the transaction makes the post-closing indemnity for breach of representations less meaningful (such as a public company deal without a major selling shareholder).

The provisions of W&I insurance may vary from case to case, and to our knowledge, in local practice, there are no typical (i) excesses/policy limits, (ii) carve-outs/exclusions, or (iii) costs for such insurance, which would largely depend on the size of transaction, the business of target company and the due diligence exercise of the buyer.

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

In addition to the survival period of the representation, it is common that the aggregate liabilities of the sellers would be capped at 100% of the purchase price, and liabilities for breach of non-fundamental representations would be capped at 20–30% of the purchase price. On the other hand, the parties would usually consider the nature of the target company's business and the deal size when negotiating the amounts of *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)?

We have seen escrow or holdback arrangements in some cases but we do not think they are common in local PE deals.

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 buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

According to our experience, when the seller needs comfort, a PE buyer may present to the seller a commitment letter issued by it to its SPV (the buyer), indicating its commitment to make equity investment in the SPV for the transaction. With respect to debt finance, a PE buyer (for its own benefits as well) would obtain a certain fund commitment from the lenders before signing a definitive agreement with the seller, which may also be presented to the seller.

In local practice, the seller (as a third party) usually has no right to enforce such commitment letters pursuant to the terms and conditions thereof. However, theoretically speaking, if the definitive agreement for the transaction and the relevant commitment letters are governed by Taiwan law, the seller may have a right to enforce the relevant commitment letters for and on behalf of the buyer for the general benefits of all creditors of the buyer (instead of in the name of the seller and for its own benefit).

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

According to our experience, "break fee" arrangements are not prevalent in local practice.

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 Taiwanese IPO may not be an attractive way of exit due to the relatively low price-to-earnings ratio of the Taiwan stock market, and PE investors usually prefer to carry out IPOs in other jurisdictions. However, due to the special relationship between Taiwan and China, the approval of Taiwanese regulators for a PE investor's acquisition of a Taiwanese target company may be given on the condition that the PE investors shall undertake not to have the target company list in stock exchanges in China or Hong Kong in the future, which may limit the IPO exit by PE investors.

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

In local practice, for an IPO, the directors and supervisors of such company, as well as the shareholder(s) holding more than 10% of the shares of the company ("10% Shareholder"), are required to place their shares with the Taiwan Depository & Clearing Corporation ("TDCC") for central custody. The total number of shares placed in custody shall also reach a certain percentage (5–25%, depending on the number of total issued shares) of the shares of the company.

The required period for such central custody is one year. After the first half-year of the IPO, the directors, supervisors and 10% Shareholders will be able to retrieve 50% of their shares, and the remaining 50% may be retrieved after the second half-year of 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?

From our observation, the dual-track exit process is not common in Taiwan. As mentioned above in question 7.1, an IPO does not seem to be considered an exit priority, so there were many more cases where PE sellers exited through 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).

The most common source of debt finance used in PE transactions is bank loan – specifically, syndicate loans extended by domestic and/or foreign banks. Other debt financing instruments are rarely seen in local practice.

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 indicated above under question 8.1, the most common source of debt finance used in PE transactions is bank loan. While there are no legal requirements or restrictions that would specifically impact the nature or structure of the debt financing of a PE transaction, from our experience, Taiwan regulators may have concern if the loan granted by domestic banks exceeds 60% of the consideration for the transaction.

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

There are no particular recent trends in the debt financing market in Taiwan. Most PE investors still prefer to arrange for bank loans (as described above in question 8.1) as the source of debt finance.

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 Taiwan, a tax implication normally considered in PE transactions is, from the perspective of the seller, whether the transaction would be subject to the securities transaction tax (0.3% of the transfer price) on the sale of the securities and/or the income tax (for which the highest tax rate is up to 40% for individuals).

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 indicated above, it is commonly arranged that the management (rollover participants) hold the equity of an offshore entity upon closing of the PE transactions, in which case the focus would be more on the tax law of the jurisdiction where the offshore entity is incorporated. However, a Taiwanese individual's non-Taiwan-sourced income from his/her equity in the offshore entity should also be included in the calculation of the alternative minimum tax of Taiwan.

In case the management (rollover participants) holds the equity of an onshore entity upon closing of the PE transactions, the tax implication would depend on the type of equity instruments granted to the rollover participant. For example, in case of employee stock options, the Taiwanese individual holder will be taxed (income tax) on the difference between (i) the "then-fair value" when the option is exercised, and (ii) the exercise price of the option.

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?

See question 9.2.

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?

There have been two significant legal developments since 2018:

(1) In November 2018, the Justices of the Constitutional Court granted a minority shareholder in a cash-out merger in 2007 an appraisal right in Interpretation No. 770, on the basis that the then effective M&A Act failed to afford sufficient

protection and was therefore unconstitutional. The Justices of the Constitutional Court further opined that the current M&A Act (in effect since 2016) is also flawed in terms of shareholder protection, including with regard to disclosure requirements. Public comment on this Constitutional Court interpretation is that the validity of the current M&A Act is not immediately affected. On the other hand, the competent authority is expected to amend the current M&A Act in response to the Constitutional Court's concerns, including potentially raising the extraordinary general meeting ("EGM") voting threshold for delisting, thereby affording minority shareholders more protection.

(2) The government has proposed to amend the Statute for Investment by Foreign Nationals, which governs foreign investments, by replacing the current prior approval system with a post-closing notification system for deals under a certain size. The proposed amendment aims to shorten the foreign investment review process. By and large, the proposed amendment is expected to be friendlier to cross-border M&A deals; however, there is no definitive timeline for the legislative process.

(3) The government made relevant amendments to regulations governing PRC investors' investment in Taiwan to prevent the circumvention of the investment control. For example, according to the amendments: (i) stricter criteria were adopted for identifying PRC investment made through third-area intermediary; and (ii) PRC investors wishing to control a Taiwanese company (other than those listed on the TWSE or Taipei Exchange or traded over the Emerging Market of the Taipei Exchange) via contractual arrangement are also required to apply for regulatory approval. In addition, investment directly or indirectly sponsored by the Chinese Communist Party, or any governmental or military agencies of PRC, is severely restricted. Given so, the transaction structuring must be carefully structured to meet the requirements applicable to PRC investors for making investment in Taiwan.

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

Considering the current government's conservative attitude toward China investments, any transactions involving Chinese funding is under higher scrutiny by Taiwan regulators. Given the sensitivity of China investments in Taiwan, buyers and sellers might need to spend more time structuring their transactions to meet local restrictions/requirements. In addition, as a result of recent developments in Hong Kong, it is likely that Hong Kong will also be considered as China by Taiwan regulators in the future.

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 timeline of legal due diligence of PE transactions ("Legal DD") varies from case to case. According to our experience, it is commonly seen that the Legal DD period may take one to two months. The materiality thresholds for a PE transaction should really depend on individual cases, and the size and operation of the target company (as measured by, for example, assets and revenues) as well as the requirements of the insurer for W&I insurance are normally the important factors in determining the thresholds. As to the scope of the Legal DD, PE investors would normally request a comprehensive Legal DD on the target 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.)?

Not to our knowledge. However, the relevant issues would definitely be a concern of PE investors and would need to be checked during the Legal DD.

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?

No, except for the following rule regarding "piercing the corporate veil" under the Taiwan Company Act. According to the Taiwan Company Act, if a shareholder (i.e., PE investor) abuses the status of the company (i.e., portfolio company) as a legal entity and thus causes the company to bear specific debts and it is apparently difficult for the company to pay such debts, and if such abuse is of a severe nature, the shareholder shall, if necessary, be liable for the debts. This rule is rather abstract and relatively new under Taiwan law, and its applicability is subject to a court test on a case-by-case basis.

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?

Practically speaking, PE investors wishing to invest in Taiwan must not overlook the fact that the Taiwanese authorities tend to take a more stringent attitude towards investments by foreign PE investors and, especially, PRC investors. Therefore, the whole review process by the relevant competent authorities might be time-consuming. Potential PE investors are advised to seek professional assistance from local advisors to better understand the application requirements and process, as well as the authority's policy and recent practice, to ensure that PE transactions can be conducted smoothly.

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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?

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, flotations and bolt-on transactions. Accompanying a majority of these transactions will also be the leveraged financing/refinancing of such deals from a variety of debt sources.

Based on the British Venture Capital Association ("BVCA"), the value of PE investments in the UK went up from £22.2 billion in FY 2017 to £25.1 billion in FY 2020. With the backdrop of Brexit and the uncertainty of the COVID-19 pandemic, the PE market fell away sharply during the latter part of H1 2020. The impact on market activity was significant, with announced PE exits dropping 70% in May 2020 *versus* May 2019. However, just as sharply as it fell away, PE dealmaking returned during H2 2020 with vigour and with higher asset valuations than had been seen previously, reflecting investors' demands for returns in a low-yield environment. The PE market continues to perform well, outpacing most other markets.

A notable trend in the PE market during 2020/2021 (among many such trends) has been the number of take-private transactions by PE investors. This demonstrates the amount of dry powder available in the PE markets. It also reflects PE investors' willingness to pay higher premiums due to their ability to maximise the value of such target entities post-acquisition, with fewer administrative and governance hurdles.

1.2 What are the most significant factors currently 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 that the PE industry may face from time to time.

London, in particular, hosts many of the leading European markets and participants that are required for PE investing: sources of investor capital; debt lenders; debt markets and many others. This concentration of markets and market participants has led to most of the key U.S. and European PE investors having a presence in the city.

Whilst Brexit dominated the headlines in Europe during 2020 and parts of 2021, the PE industry appears hopeful that investors and founders alike will be given new opportunities to use the UK as a platform investing country. The COVID-19 pandemic potentially has more far-reaching consequences for the UK PE industry and this is discussed at question 1.3 below.

1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

Immediately following the COVID-19 pandemic reaching its peak in March/April 2020, PE firms worked to ensure the safety of employees and customers and to shore up portfolio companies to enable them to ride out the pandemic (including taking on various sources of private and government-backed financing). The impact on PE market activity was significant, with announced PE exits dropping 70% in May 2020 *versus* May 2019.

As discussed above, from H2 2020 onwards, the PE markets rebounded strongly in the UK (and internationally). Difficulties with deal sourcing and execution, such as an inability to meet face-to-face, have largely been overcome, as is demonstrated by the rebound and the amount of capital being deployed in PE deals. The key factors that we see as enduring are:

- Valuations: PE deals are often valued on a multiple of the target business' earnings, and specifically its earnings before interest, taxes, depreciation and amortisation ("EBITDA") (amongst other methods). Buyers and sellers are having to agree adjustments to such EBITDA figures to reflect the unusual impact of the COVID-19 pandemic on the trading of target businesses. How to treat such adjustments is case-specific and a point that continues to evolve.
- Government-backed finance: Many businesses took on government or government-backed financing during the COVID-19 pandemic. The impact of this financial support continues to impact a number of sectors. PE investors are having to focus attention on this financing in target and portfolio businesses, including its impact on their ability to add/extract value from the investment.
- New sectors: The COVID-19 pandemic has changed the way that many of us live, work and consume, which has led to the expansion of some business sectors and a contraction of others. For example, the travel sector has suffered, whereas healthcare has benefitted. The ongoing impact of COVID-19 continues to affect both existing investments and current dealmaking in such sectors.

UK Government intervention into the economy to address COVID-19 has been well-publicised. Some key impacts on the PE markets have been:

- Interest rates: Base rates across the globe have been kept low, and the UK is no exception. This has encouraged capital to seek higher returns in sectors such as PE.
- Employment markets: Establishment of furlough schemes have propped up many businesses throughout the COVID-19 pandemic and kept money in the hands of consumers. PE participants will closely follow the impact of the end of such schemes.
- Loans and insolvency protection: Many businesses benefitted from direct and indirect government financial support, and certain legal protections from insolvency. Again, the end of such schemes going forwards may have an impact on which businesses are able to continue.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

There has been a continuation of the recent shift in non-traditional PE funds, such as sovereign wealth funds, pension plans and family offices moving beyond their primary focus on minority positions to increasingly serve in a "control" or lead investor-type capacity on direct investments in the PE space. The genesis of this trend has been the desire of these investors for greater control, reduced fees and greater returns on invested capital, particularly in the traditional PE space.

This shift in focus has created additional competition for traditional PE funds and is resulting in increased variation in the deployment of capital by these non-traditional PE investors across the capital structure. Many of these non-traditional PE funds are not used to a lead investor role and are therefore still refining their approach to diligence, transaction terms and governance.

Given the profile of the stakeholders in sovereign wealth funds, pension plans and family offices, there is an added emphasis on environmentally and socially responsible investments and this is expected to continue to be an area of significant focus looking ahead.

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 acts as the holding company for a chain of corporate entities. The bottom entity in the acquisition chain ("Bidco"), acts as the purchaser 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 that 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 and Jersey, etc.) will impact upon such UK stamp duty planning.

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 PE 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 business asset disposal relief (formerly 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 PE 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 that 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 PE 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 the 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 that 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 completion 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, in some cases, 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 publicly.

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 that 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 that 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 that 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 that 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 (save for those expressly set out in any shareholders' agreement). 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 an aggrieved shareholder 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 that purport to offend the principles around proper corporate behaviour, outlined in the answer to question 3.3 above, can be problematic to enforce. In addition, certain legislation, for instance the European General Data Protection Regulation ("GDPR"), the UK Data Protection Act 2018 and the UK GDPR, which governs the transmission and collection of data in the European Union and the UK, can add further challenges to older shareholders' agreements that 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 that 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, e.g. 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) a failure of the appointed director to act as they expect or would prefer (for example, where the relevant director is subject to statutory duties requiring certain behaviour, such as placing 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.

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 (and therefore to the entire cohort of shareholders of such company).

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, foreign direct investment 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/foreign direct investment filings and industry-specific regulatory mandatory approvals or consents. As a rule, participants in the competitive PE market avoid including conditionality in their deal documentation, to ensure a high degree of deal certainty.

There has been a reduction in financing conditionality in recent years, 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; (iv) shorter seller liability time periods, in many cases regardless of whether W&I insurance is being used; and (v) fewer conditions to the completion of transactions, i.e. typically only those that are mandatory and/or suspensory for the transaction in the key jurisdictions of the target's operations.

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 that 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 completion 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 and therefore maximise 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 for PE sellers in the UK market, 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 UK market is a seller's market, "locked-box" consideration structures are commonly accepted by buyers except in limited circumstances, including where 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 that 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 (i) a private equity seller, and (ii) the 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-completion 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-completion period; and (iv) certain limited covenants regarding the provision of information during the pre-completion 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 lasting throughout pre- and post-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?

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 that 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, jurisdictions of operation, 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 the enterprise value, with the most common range being between 15% 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 an excess as low as £1 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 that 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 that 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 that 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 buyer (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

The market has evolved such that buyers will typically provide: (i) an equity commitment letter ("ECL") in respect of the equity portion of their consideration; and (ii) "certain funds" committed debt papers ("Debt Commitment Papers") from a lender in respect of the debt portion of their consideration. In some circumstances, a buyer may provide an ECL in respect of the entire consideration and address the debt portion privately behind the scenes, although we see this less frequently in mid- and upper-market transactions.

The ECL will come from the buyer's PE fund itself, will be addressed to the buyer's Bidco, and may sometimes also be addressed to the seller. Such ECL will generally include covenants that the fund will (i) call required capital from its investors to fund the equity portion of the purchase price, and (ii) fund Bidco with the equity capital required to fund such relevant portion of the purchase price (or a seller's damages claim for failure to complete), which is subject only to the satisfaction of the conditions in the share purchase agreement. This ECL will customarily also include certain commitments from the PE sponsor aimed at ensuring Bidco draws down the requisite funds under the Debt Commitment Papers in order to complete the transaction.

The seller will usually be able to enforce the ECL commitment directly, or on behalf of Bidco, 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 Debt Commitment Papers 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.

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 PE 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 U.S., 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):

- 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. Following the end of the "lock-in" period, it is likely that an "orderly market" period (perhaps of up to 12 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, a period of at least six months following an IPO will apply. This means that no actual "exit" (in terms of realising value from the investment) will have been effected by the PE sponsor at the completion 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?

The first quarter of 2021 saw record breaking exit values generated in the UK. Both market volatility and liquidity (across debt, public and PE markets) remain high and have sustained strong valuations. It is not uncommon to run a dual-track exit process, though a greater number of deals are 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 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 likely 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, usually on a floating rate. 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 ("TLB") – a non-amortising, senior secured term loan usually under NY law. Investors in TLB include a mix of traditional bank lenders and institutional investors and they are designed to tap greater availability in the U.S. debt syndication markets, relative to the European Markets.

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 ongoing or maintenance financial covenant, usually a leverage ratio) and, for stronger borrowers, "covenant-lite" structures (that is, where the loan agreement contains no maintenance financial covenants or only a springing leverage covenant for the benefit of the revolving creditors).

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 UK is, generally speaking, an investor-friendly jurisdiction and 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 (compared to 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 PE transactions.

For example, in the current sensitive political and regulatory climate, market participants need to be especially careful with regard 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 buyout transactions of public (as opposed to private) companies 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 completion of the acquisition.

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

The recent trends were, until the COVID-19 pandemic, mainly in favour of the borrower/sponsor side. We are seeing ever more flexibility in the additional debt baskets and in the permitted payments baskets too. 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. The COVID-19 pandemic massively interrupted deal-flow in H1 2020, but as of now (October 2021), deal-flow is back where it was immediately prior to COVID-19. Terms that tightened during 2020 are also back to where they were pre-COVID-19.

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, to 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 increasingly complex 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 favourable tax treatment for carried interest has become more difficult to achieve, capital gains tax remains available on carried interest returns in certain circumstances (at a 28% special rate for carried interest, compared with the normal 20%). 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 business asset disposal relief (formerly 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 and corresponding economic and voting rights for at least two years. With effect from 11 March 2020, a lifetime allowance of £1 million of gains is eligible for business asset disposal relief (a significant reduction from the £10 million of lifetime gains eligible for relief prior to such date).

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 until any disposal proceeds are received and will want to maximise the availability of business asset disposal relief (although this will be less of a priority following the significant reduction in the lifetime allowance noted in question 9.2). 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 HM Revenue & Customs ("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. Measures impacting the PE industry include:

(a) The anti-hybrid rules that 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") that 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, the adoption of the second Anti-Tax Avoidance Directive ("ATAD II") has extended the scope of the hybrid mismatch tax rules to arrangements involving non-EU countries and so-called "reverse hybrid" mismatches. This further complicates the anti-hybrid issues discussed above. Following Brexit, the UK has largely stepped away from the mandatory disclosure rules introduced by the sixth amendment to the EU Directive on Administrative Cooperation ("DAC6") and proposes to introduce new rules in 2021, in accordance with the OECD's Mandatory Disclosure Rules.

On a domestic level, changes to the qualifying conditions for business asset disposal relief and a reduction in the available lifetime allowance from £10 million to £1 million have had a significant impact on many management teams.

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 chapter, 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), GDPR (which governs the transmission and collection of data in Europe) and the Takeover Code (referred to above). The National Security and Investment Act ("NSI") will enter into force later this year (2021) and extend the government's powers to scrutinise and intervene in investments to protect national security. Although the UK chose not to adopt the EU Sustainable Finance Disclosure Regulation or the Taxonomy Regulation following Brexit, environmental, social, and corporate governance ("ESG") matters remain high on the legislative agenda and the UK's evolving ESG regulations will affect both the operation of and reporting by PE investments.

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, PE and any other alternative investment firms into a regulated framework, in order to monitor and regulate their activity). All investors, including PE funds, could be subject to UK national security screening under the NSI, which will enter into force later this year (2021) and will cover investments made by UK or non-UK investors in targets having a presence in the UK through a subsidiary sales or activities in the UK. Investments in key sectors will be subject to mandatory notification; for investments in other sectors, a voluntary filing may be advisable.

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, ESG, 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 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. In addition, the W&I insurance policies that are very often placed in connection with PE transactions generally exclude bribery and corruption from their cover.

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 by failing to implement adequate procedures for its portfolio company, 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. A degree of uncertainty accompanied the UK's departure from the European Union on 31 January 2020. However, PE investments and exit have continued apace in 2021 and the UK's legal divergence from the European Union has proven gradual. 2021 has seen several government initiatives intended to promote investment and job creation in the UK, such as the proposed creation of up to 10 freeports in locations around the UK. Aside from Brexit, many other factors remain that can influence investments by PE sponsors in the UK and there is not room to cover them all here. Topics of particular prominence in the UK at the time of writing (October 2021) are the ongoing impacts of the COVID-19 pandemic (addressed elsewhere in this chapter) and also the new NSI, which will subject investment in industries thought to be of strategic significance (e.g. defence, life sciences and healthcare) to mandatory screening. This legislation is a response to concerns around the maintenance of national independence in certain areas, influenced by greater geopolitical uncertainties. These concerns are leading to a proliferation of national security regimes around the world.

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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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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?

U.S. private equity ("PE") deal activity faced turbulence in early 2020 as a result of the onset of the COVID-19 pandemic in the United States, with a dramatic slowdown experienced during Q2 2020, but deal activity rebounded strongly in the second half of 2020. Both deal volume and deal value for 2020 ultimately finished below the near record-setting levels observed in 2019, but the rapid recovery in activity through the end of the year generated significant optimism in the industry, and deal activity has since hit record levels in the first half of 2021. Commitments in respect of PE fundraising decreased during 2020 compared to 2019 but rebounded during the start of 2021.

Since the dramatic market recovery experienced in the second half of 2020, PE sponsors have continued to be confronted with highly elevated valuations for new platform companies and seller-friendly terms created by expedited, competitive auctions. These valuations, coupled with record levels of dry powder and the lack of suitable targets, have continued to create a challenging investment environment for buyers who are looking to quickly deploy capital. As a result, there has been a continued focus on portfolio company add-ons and alternative transactions, such as carve-outs, strategic partnering transactions, minority investments, club deals, growth investments, structured equity investments, private investments in public equity ("PIPEs") and take-private transactions. In addition, PE sponsors have focused significant attention on readying existing portfolio companies for exits in order to take advantage of the robust market, and they have increasingly been eyeing strategic buyers and public markets for exits. Investments in the healthcare and technology industries fared particularly well during the COVID-19 pandemic, but sponsors have also been making opportunistic investments in industries that were hard hit by the pandemic, such as hospitality and retail.

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

Over the last few years, the dearth of suitable targets has resulted in extremely competitive auctions, which in turn has resulted in historically high 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. While it initially seemed like the COVID-19 pandemic would challenge some of these patterns, after a brief slowdown in activity early in the pandemic, these trends have generally continued unabated. In addition, recent regulatory reforms involving the Committee on Foreign Investment in the United States ("CFIUS") have led 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 are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

Given the trends observed since the early days of the COVID-19 pandemic, it seems unlikely that COVID-19 will have significant long-term effects on the U.S. PE industry. However, parties have developed an increased level of comfort with conducting processes in a virtual or partially virtual setting, including fundraising.

U.S. government intervention in the economy in response to the COVID-19 pandemic has included a number of facets, including, among other things, loan programs targeted at small businesses, such as the Paycheck Protection Program ("PPP"), payroll tax deferrals and payroll tax credits under the CARES Act, and temporary modifications of certain aspects of the Tax Cut and Jobs Act of 2017. Stimulus has not been aimed at PE, although PE funds and their portfolio companies have been able to take advantage of certain benefits. They have also had to navigate stimulus programs through the acquisition of targets that have availed themselves of benefits – particularly PPP loans, which were generally unavailable to PE funds and most portfolio companies as a matter of law. PPP loan recipients face additional scrutiny and hurdles when undergoing a transaction, but, given the life cycle of PPP loans and the related government funding, few are expected to remain outstanding by this time next year.

1.4 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

Over the past several years, the concentration of capital in large, multi-strategy asset managers has increased, leading to a corresponding increase in the number of deals consummated by such managers. We expect this trend to continue, as large, multi-strategy asset managers may be better positioned than some others to take advantage of opportunities available in the current market.

Non-traditional PE funds such as sovereign wealth funds, pension plans and family offices continue to extend investments beyond minority positions and are increasingly serving as lead investors in transactions, which has created additional competition for traditional PE funds.

In addition, pension funds, insurance companies and other investors of large pools of capital will likely continue increasing their allocation to alternative investments, including 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, including structured equity.

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 continued support during the period between signing and closing, releases, indemnification and restrictive covenants. However, depending on the applicable state law, enforceability issues may arise.

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 for acquirors 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. For certain regulated businesses, permits and licenses may need to be transferred or reissued. 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 most often comprises 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 issuances 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 be required to forego certain rights that they 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 multiple on invested capital upon exit. Time-based awards typically accelerate upon the PE sponsor's 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 the employee's termination at fair market value or the lesser of fair market value and the 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 the capital structure of the portfolio company, but management equity pools for portfolio companies typically range from 7.5–15% of equity on a fully diluted basis, with the higher end of that range being more common with smaller equity investments and equity structures where the PE sponsor holds more preferred equity.

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 after a specified period of time, upon normal retirement, 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 ("LPs")) 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, LLC agreement or LP agreement, depending on the form of the entity. These agreements ordinarily contain, among other things: (i) transfer restrictions; (ii) rights of first refusal or first offer; (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 fiduciary and other duties to the extent permitted by 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 directors. As a result, major corporate actions are ultimately indirectly controlled by the PE sponsor. If a PE sponsor takes a minority position, veto rights will generally not be included in underlying governance arrangements unless the 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 specified shareholders or classes of equity contained in a shareholders' agreement or LLC agreement if applicable, and are generally enforceable. For corporations, although less common, negative covenants can also be included in the charter, 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 generally be subject to their overriding fiduciary duty owed to the portfolio company, unless such duties have been validly disclaimed. 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 the 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 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 are made in the best interests of the company and its shareholders and not based on personal interests or self-dealing. For Delaware corporate entities, these duties may not be waived.

For PE sponsors organizing their investment vehicles as LLCs or LPs in Delaware, the underlying LLC or LP agreement will often include an express waiver of fiduciary duties owed to minority investors. Absent an express waiver, courts will apply traditional corporate-like fiduciary duties. Other duties deemed included in LLC or LP agreements such as duties of good faith and fair dealing may not be waived. In addition, shareholders', LLC and LP 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. These agreements also typically provide that portfolio companies (and not PE sources) serve as the first source of indemnification for claims against PE sponsor employees serving on the portfolio company's board.

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', LLC and LP agreements are generally governed by and must be consistent with the laws of the state of the entity's formation. LLC and LP agreements, which are contracts among the company and its members or partners, 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 state laws outside the state of formation may render certain provisions unenforceable.

Non-competition and non-solicitation provisions in shareholders', LLC and LP 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/or geographic scope may render provisions unenforceable or subject to unilateral modification by courts. Other contractual provisions such as transfer restrictions, particularly for corporate entities, are subject to public policy limitations.

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. In 2019, the U.S. Department of Justice ("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. PE investors should also be aware that some U.S. states have been enacting gender diversity requirements for the boards of companies organized and/or headquartered in the applicable state, and NASDAQ has proposed new listing rules regarding board diversity and related disclosure.

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 as directors (subject to certain exceptions in the case of an LLC or LP where fiduciary duties of directors are permitted to be, and have been, expressly disclaimed). Directors of corporations 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 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 (absent a waiver under the circumstances discussed above) and that conflicts of interest create exposure for breach of duty claims. Finally, while the fiduciary duties to the company remain the same, the ultimate stakeholders might change when a company is insolvent or in the zone of insolvency – in such situations, directors may also owe fiduciary duties to certain creditors of the portfolio 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?

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 and may not engage in acts of self-dealing. In addition, directors appointed by PE firms who are also officers of the PE firm itself owe potentially conflicting fiduciary duties to PE fund investors. Directors need to be cognizant of these potential conflicts and seek the advice of counsel.

4 Transaction Terms: General

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

The timetable for a transaction 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 (2021: US$92 million). In most circumstances, the HSR process takes approximately one month and is conducted between signing and closing. Parties can expedite review by filing based on executed letters of intent or by requesting early termination of the waiting period; however, the U.S. Federal Trade Commission and the DOJ have recently been applying greater scrutiny to early termination requests, including by issuing a temporary suspension of early terminations in early 2021 that was still in effect at the end of Q2 2021.

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 and regulatory changes, 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. Recent CFIUS reforms that have been implemented pursuant to the Foreign Investment Risk Review Modernization Act of 2018 ("FIRRMA") have expanded CFIUS' powers and also 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 or FCC approval) 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 financing 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 retention (which refers to the self-insured deductible) and insured limit 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 remain 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 may be obtained.

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%.

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 (i) a private equity seller, and (ii) the management team to a buyer?

With the 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 where sellers provide no indemnification 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 their 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 0.75–1% retention (stepping down to 0.5% after one year), six years of coverage for breaches of fundamental representations and three years of coverage for breaches of 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. In addition, exclusions have recently been expanded to include COVID-specific exclusions and liabilities related to PPP loans.

Despite competition among R&W insurers, consistent with other insurance markets, pricing of R&W insurance policies has tightened, with premiums and broker fees commonly around 3.25% 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.

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 walk-away R&W insurance transactions, representations and warranties typically do not survive the closing.

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 deductible 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, as do special escrows to address issues identified during due diligence.

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 buyer (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 with equity. 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 PE 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. IPOs accomplished through acquisitions by SPACs (i.e., de-SPAC transactions) have become increasingly common.

Unlike third-party sales, PE sponsors continue to own significant amounts of portfolio companies' equity following an IPO or de-SPAC transaction. As a result, PE sponsors' ownership interests and rights and the nature of any 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 following the IPO. After the 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 the timing, volume and manner of sale, and in club deals they may remain subject to coordination obligations with other sponsors.

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?

Depending on market conditions, PE sponsors may simultaneously pursue 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 the most common, although exits through SPAC IPOs have become increasingly 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 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 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, although notably high-yield bond issuances increased substantially year over year from 2019. Query whether an anticipated future environment of rising interest rates in the United States may tilt borrowers back slightly, towards fixed-rate bonds that continue to be available at historically low coupons, potentially allowing them to avoid the effects of rising interest rates and floating rate instruments.

Direct lenders continue to be important market players and have competitive advantages over traditional bank lenders. Those advantages initially stemmed from constraints on traditional bank lenders imposed by capital requirement guidelines and from regulatory restrictions affecting loans exceeding certain leverage thresholds. While those guidelines and restrictions have been pulled back for now, borrowing from direct lenders has continued to be a trend in light of the amount of money in the market generally and such lenders' flexibility in commitment amounts, loan terms and speed of execution.

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 push for deregulation in the United States continued with a rollback of Dodd-Frank Act regulations, including the Volcker Rule, a regulation that was meant to prohibit banks from making speculative bets with their own capital. The result was a final Volcker Rule in October of 2020, which increased potential transactions that would be permitted by covered funds or exempted from covered funds restrictions, addressed extraterritorial treatment of certain foreign funds, eliminated the 3% cap on ownership of a venture capital fund and allowed banks to invest in credit funds, among other changes. With a new administration in 2021, there has been discussion that leveraged lending restrictions may increase by instituting mandatory limitations (rather than mere guidance) on leverage ratios and implementing regulatory oversight over direct lenders.

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

The most important trends in the U.S. loan market relate to the after-effects of the COVID-19 pandemic on the credit facilities of portfolio companies and include the following:

- Despite disruption to the loan markets due to the lockdowns across the United States, loan markets have proved resilient, benefitting from low interest rates and pent-up demand in the mergers and acquisitions market. Generally, borrowers are obtaining favorable terms and loan documentation in line with what was available in the borrower-friendly, pre-COVID-19 market. PE sponsors are taking advantage of this market buoyancy by working on a record number of dividend recapitalizations.
- PE sponsors and management have carefully reviewed the definition of "EBITDA" in credit facilities and have pushed to have specific addbacks attributable to the health crisis and attendant costs and expenses that may be incurred in connection therewith. These addbacks have tended to be relatively circumscribed.
- With government-mandated lockdowns lifting, PE sponsors, management and lenders are seeking to enter into longer-term solutions for businesses affected by the pandemic. In addition, borrowers with less certain credit quality are facing a hangover of terms that were implemented in the COVID era, including "anti-hoarding" provisions that would require the regular repayment of cash over an agreed-upon threshold or a prohibition on borrowing when cash balances exceed an agreed-upon level.

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 – under the current tax regime – on long-term capital gains (but do have certain 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 – under the current tax regime – 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 deferrals 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?

There have been a number of significant changes in recent years. Significant changes to the tax audit process have become effective, and significant tax reform enacted in 2017, commonly referred to as the Tax Cuts and Jobs Act, resulted in many significant changes to the U.S. income tax system. Most recently, and related to the COVID-19 pandemic, there has been a series of tax legislation and non-legislative changes impacting the U.S. income tax system. This has included new rules that create or modify tax laws related to deductions for interest expense, use of carrybacks, and deductions for the expense of certain types of property, the extension of deadlines for tax payments and tax returns, payroll tax incentives including new refundable tax credits and payment deferrals. It is possible that further legislation or other initiatives relating to COVID-19 matters could be enacted.

These changes could impact the timing and amount of deductions and tax payments of portfolio companies, and therefore will be relevant to PE transactions involving U.S. companies.

Careful consideration and attention should be given to developments in this area. Future tax legislation and other initiatives could result in additional meaningful changes to the U.S. income tax system.

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?

See question 1.3 for a discussion of certain government programs implemented in response to the COVID-19 pandemic. The Tax Cuts and Jobs Act was enacted in 2017 and, more recently, there have been legislative and other tax initiatives related to the COVID-19 pandemic. See section 9.

The enactment of FIRRMA in August 2018 and the implementation of related regulations that culminated in late 2020 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, or otherwise deal with technologies, that are deemed to be sensitive from a national security perspective. Transactions involving Chinese investors, in particular, continue to be 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. Investments by non-U.S. entities that are partially or wholly owned by non-U.S. governments also are subject to heightened scrutiny and might trigger mandatory filing requirements. There are exceptions, however, for certain PE investments made through partnerships in which the general partner is a U.S. entity or is domiciled in an "excepted state" (which currently includes Australia, Canada, and the United Kingdom).

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. PE sponsors have been increasing their focus on due diligence regarding ESG and data security.

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 and often insist on compliance enhancements to be implemented as a condition of investment.

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, employee benefit and labor laws, the FCPA and consolidated group rules under tax laws.

The two most common areas of concern relate to potential liabilities under U.S. environmental laws and employee benefit laws. The Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") can impose strict liability on owners and/or operators of a facility with respect to releases of hazardous substances at the facility owned or operated by the portfolio company. However, unless PE sponsors exercise actual and pervasive control of a portfolio company's facility by actually involving themselves in the portfolio company's daily operations at the facility or its environmental activities, they should not be exposed to liability as an operator of such facility. Parents also should not have indirect or derivative liability for the portfolio company's liability under CERCLA, unless 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 (both at the federal and state level) 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 2021. See section 10.

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