THE INTERNATIONAL COMPARATIVE LEGAL GUIDE TO: PRIVATE EQUITY 2023/2024

9TH EDITION

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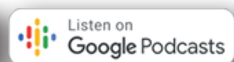

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Preface

We are delighted to have been invited to once again introduce the 2023 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 now in its ninth edition, which is itself a testament to its value to practitioners and clients alike. Dechert LLP continues to serve as the *Guide*'s contributing editor.

In a world of higher interest rates and other macroeconomic, social and political developments, it is critical to maintain an up-to-date guide regarding legislation and practice across a variety of jurisdictions. This 2023 edition accomplishes that objective by providing global businesses leaders, in-house counsel, and international legal practitioners with ready access to essential information regarding the current legislative framework and evolving practice for private equity transactions in 22 different jurisdictions, each written by experienced practitioners. This edition also includes one expert analysis chapter, which discusses pertinent issues affecting the private equity industry, transactions and legislation.

Dr. Markus P. Bolsinger & Christopher Field
Dechert LLP

2023 and Beyond: Private Equity Outlook for 2024

Siew Kam Boon

Sarah Kupferman

Sam Whittaker

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Introduction

The global private equity (PE) industry, after enjoying record-setting years in 2021 and 2022, is now facing macroeconomic headwinds. Inflation and related rising interest rates, a tight labour market in the case of the United States, more robust anti-trust enforcement in various jurisdictions, as well as geopolitical uncertainty, and valuation expectations that do not yet reflect the economic realities of the moment have together served to slow PE deal activity. Through the first half of the year, 2023 PE deal activity in the United States, Europe, and Asia lags behind that of 2021 and 2022 in terms of deal count and deal value. Similarly, fundraising activity is down overall in 2023 so far. However, even as the deal environment is proving challenging, PE sponsors continue to hold record amounts of dry powder to deploy.

In this environment, PE sponsors have increasingly focused on platform balance sheets and more distressed sectors and companies, made use of consideration-deferment methods and more frequently turned to alternative sources of capital to complete transactions. In 2024, creativity and agility will continue to be key for PE sponsors to identify and win investments and to realise value.

Trends in the PE Market

The PE market focuses on restructurings

As a result of the current deal environment, PE sponsors have sharpened their focus on the liquidity of their existing portfolio companies. Higher borrowing and labour costs have left companies with floating interest rates and borrowing arrangements unprepared for the levels of cash-burn that we are presently seeing, forcing PE sponsors to concentrate their efforts on portfolio assets that can meet their capital requirements during this period of expensive debt. An increased demand for liquidity has in turn led to the question of how much support PE sponsors will give portfolio companies through capital injections (and if they will be willing to do so without a short-term positive return). Increasingly in some cases, restructuring is being seen as a viable alternative solution.

Businesses in sectors that have pricing power, and which are able to pass on increased costs of inflation to their customers, are in a better position, but those that cannot pass along such costs may benefit from a restructuring that deleverages their balance sheets. For this reason, some PE sponsors that focus primarily on restructuring and distressed businesses have sought more control opportunities in operationally sound businesses, particularly in sectors with higher cost structures, that struggle to pass costs related to wage pressures and inflation to end-consumers. PE sponsors operating in this space have focused particularly on the healthcare industry, due to the continuous pressure from increasing wages, lower reimbursement rate and regulatory uncertainty. Other sector focuses have included packaging businesses, airlines, real estate, and industrial businesses. In pursuing these opportunities, PE sponsors anticipate that, through the headwinds, these businesses have solid operational and management expertise and ample liquidity and resources to go through a restructuring process that will help ensure that the balance sheet and capital structure are set up for success. With the opportunities that distressed businesses present to PE sponsors, what will remain a challenge throughout 2023 and into 2024 is distinguishing which businesses present a successful opportunity and which will simply need to be managed, while ensuring that management can adapt to these new environments.

Bridging valuation gaps

One of the features of the present deal environment is buyer and seller disagreement on valuation. PE sponsors can try to resolve these disagreements by deferring some of the consideration offered. This deferment can take the form of an earnout or, somewhat more rarely, seller financing.

In transactions involving earnouts, sellers accept a mix of consideration that includes a contingent right to receive consideration in the future based on the performance of the acquired company. By contrast, in transactions involving seller financing, buyers issue promissory notes to the seller to cover a portion of the transaction consideration. In each case, part of the consideration is deferred. However, in the case of an earnout, the deferred consideration is typically contingent on the achievement of specific levels of performance by the acquired company, while seller financing is typically not conditioned in this way.

Seller financing has an additional potential benefit, particularly in the context of sales of distressed assets, in that should

the acquired business fall into bankruptcy, the seller as a creditor stands in line to collect the proceeds of any liquidation (where the seller stands in the line depends on whether its note is subordinated and/or secured (and if secured, on the nature of the lien)).

Between 2016 and 2019 (i.e., before the economic impact of COVID-19), roughly 16% of private sales of U.S. companies or businesses publicly disclosed in SEC filings included an earnout, rising to 21% during the high-inflation period beginning in 2022 to the present. While not as common, from the beginning of 2022 to date, roughly a dozen deals publicly disclosed in SEC filings have included some seller financing, usually in the form of a promissory note.

By pushing payment of some consideration into the future, buyers and sellers are able to bridge valuation gaps and navigate rough financing waters. This can help PE sponsors acting as buyers to decrease their capital costs in this less-attractive financing environment. Sellers, for their part, can enjoy higher valuations and a chance for more overall consideration. However, these tools, especially earnouts, increase the likelihood of post-closing disputes, so the deal parties – sellers in particular – have an interest in setting earnout targets, calculation methodologies and related efforts standards as clearly and unambiguously as possible in the deal documentation.

Private credit still growing

While the uncertain availability of debt financing was one of main factors leading to reduced deal flow in the PE industry in 2022, private credit's impact on PE continued to grow, modestly in absolute terms but significantly as a share of the overall debt market in the context of the aggressive pullback by traditional lenders. The flexibility and relative speed of private credit had already proved its value to PE sponsors in the middle market over the last several years, leaving private credit uniquely positioned to compete with traditional lenders and make a push into the larger-cap deal space as larger deals faced financing headwinds in the credit crunch of 2022 and rising interest rates. With more streamlined facilities that do not depend on syndication (though private credit group deals are also a growing trend), private credit has been an attractive solution for PE sponsors in the uncertain deal ecosystem of 2022 and early 2023, even for deals of sizes that historically were the exclusive purview of large banks.

This general growth trend was confirmed by the respondents to a recent Dechert survey, the majority of whom said that their firms' use of private credit financing has increased in the past three years. Other industry surveys also indicate that 2022 saw an 89% year-over-year increase in private credit investment in emerging markets, while private credit fundraising managed to avoid following other asset classes into decline in 2022, posting about 2% growth for the year.

Notwithstanding recent PE deal volume contraction, the historic levels of dry powder in the private credit industry are poised to be deployed. This strong position for private credit lenders is coupled with the unexpected bank weakness in the higher interest rate environment as evidenced by the bank failures of early 2023. If the uncertain time for banks makes traditional lenders more cautious as the recovery in deal flow picks up pace, private credit should have an opportunity to take even more market share in the PE debt-financing space. That said, the optimism for private credit is checked in the short term by some unease among investors about how this yet-untested industry would handle an economic downturn if one does ultimately materialise in the broader economy and brings with it borrower defaults and credit downgrades.

Outlook

Notwithstanding the slower first half of 2023 in terms of global deal count and, to a greater extent, deal value, the combination of historic amounts of PE sponsor dry powder, the dynamism of credit markets and availability of strong operating businesses with challenged balance sheets creates capacity for investment through the rest of 2023 and beyond. By focusing on strong, if distressed, platforms and other businesses, deploying consideration-deferment methods, and innovatively sourcing capital, PE sponsors can realise value and secure attractive returns for their limited partners.

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Dechert has been at the forefront of advising PE firms for almost 40 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 350 PE lawyers advises PE, private credit and other alternative asset managers on flexible solutions at every phase of the investment life cycle.

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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 Australia are leveraged buy-outs and take-private transactions. In 2022, 135 PE deals were completed, with take-private deals accounting for over half of the total deal value for all PE-backed transactions.

Despite ongoing macroeconomic headwinds in 2022, the PE market in Australia is maturing and generating strong assets under management growth thanks to high levels of capital raised – particularly in the mid-market, where there is robust deal flow, attractive valuations, and less reliance on leverage. The increasing prevalence of private debt and other alternative lending in Australia has facilitated the financing of PE investments. Notwithstanding this, fund managers and investors are expected to be more discerning when deploying capital in 2023.

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

Encouraging factors include:

- strong fundraising – in 2022, PE raised record funds of A$9 billion to deploy in investments in Australia; and
- strong growth in the technology healthcare sector and, due to government-backed projects to stimulate economic growth, the infrastructure sector.

Inhibiting factors include:

- high interest rates and inflation, which increase the cost of acquisition financing and general volatility;
- market competition, with many PE firms and several other types of institutional investors chasing a limited number of high-quality investment opportunities;
- regulatory developments (e.g., see question 11.1 below);
- increasing focus on environmental, social and governance ("**ESG**") considerations, which can limit the types of companies and sectors that PE firms target; and
- decreased investor confidence in the financial projections of businesses, particularly where there are supply-chain challenges in Australia – this can lessen the likelihood of reaching an agreement on valuation.

1.3 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.

Several other types of investors are becoming increasingly active in Australian's PE market, in particular:

- **Superannuation Funds**: typically have a longer-term investment horizon compared to PE firms, focusing on long-term wealth creation, with more moderate return expectations. They have a lower risk appetite, stricter ESG investment criteria and prefer minority or passive investments.
- **Family Offices/High-Net-Worth Individuals**: tend to have a longer-term investment horizon and often look for direct investment opportunities in private companies. Their investments will be much less reliant on leverage.
- **Sovereign Wealth Funds**: typically invest in a range of asset classes, including PE, to diversify their portfolios and maximise returns.
- **Private Debt and Credit Funds** – see question 8.1 below.

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 – in the case of private companies – share and asset purchases, and – in the case of public companies – public-to-private acquisitions. Most transactions are control investments; however, recently there has been more appetite for minority investments or co-investments to help PE investors manage market risk.

The holding structure usually involves setting up a multi-tiered "holding stack" in order to limit liability, manage tax

implications and facilitate financing arrangements. The acquiring entity in the holding stack is typically an Australian corporation or special purpose vehicle incorporated in Australia, for tax reasons and to help ensure compliance with local regulations. The intermediate entities in the holding stack may be incorporated in offshore jurisdictions, depending on the tax and regulatory considerations of the PE investor and the structure of the investment.

2.2 What are the main drivers for these acquisition structures?

The choice of acquisition structure depends on factors such as (i) tax considerations of the PE firm, sellers and/or management team (see section 10 below); (ii) requirements of the lenders financing the transaction (e.g., structural subordination); and (iii) the target company's size, industry, assets and liabilities (e.g., an asset sale structure allows a buyer to "cherry pick" which assets and liabilities are to be acquired).

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

The PE investor will typically subscribe for a combination of ordinary equity and coupon-accruing preferred securities. Re-investing/rolling management or the founder will invest in the same combination (albeit sometimes of a separate class) on a *pari passu* basis. The remaining management shareholders will be issued with (usually non-voting) ordinary equity, which vests over time and/or by reference to certain performance thresholds pursuant to a management equity incentive plan.

Carried interest is structured at fund level and usually ranges between 20% and 25%. The hurdle rate (minimum annual return that the limited partners must receive before the general partners are entitled to carried interest) is often set between 6% and 10%.

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

The same drivers listed in question 2.2 above are expected to apply; however, if a PE investor is taking a minority position it will likely have less control over the choice of acquisition structure. The investor might also consider co-investment or consortium structures with one or more other institutional investors.

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 team typically ranges from 5% to 20% of the target company's total equity – this will usually be on the higher end of that range where the management team is key to the business's growth and success. Time-based vesting is often a feature, with the vesting period usually ranging from two to five years. Performance-based vesting can also be used, usually linked to financial targets, such as revenue or EBITDA growth, or operational milestones.

Customary compulsory acquisition provisions include good leaver and bad leaver events (further described in question 2.6 below), drag-along rights for the PE investor (exercisable if it is selling more than 50% of its holding and/or of the total equity in the company), tag-along rights for management (either exercisable only where the PE investor sells more than 50%, or (more favourable to management) *pro rata*) and other exit event mechanisms (including an initial public offering ("**IPO**")).

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

Usually, good leavers will be limited to managers who retire at the usual retirement age, die, become permanently disabled, or are made redundant. Bad leavers will usually be leavers who are *not* good leavers, and so will include managers who voluntarily resign, are terminated for cause, or are in breach of the shareholders' agreement. The target company's board will typically have the overarching discretion to determine that a leaver is to be treated as a good leaver.

3 Governance Matters

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

Typical governance arrangements comprise a shareholders' agreement, the company's constitution and management equity plan rules. None of these arrangements are required to be made publicly available in Australia.

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, the majority of PE investors typically have veto rights over all material and/or non-ordinary course matters in relation to the business.

Where a PE investor takes a minority position, its veto rights will be limited to more critical decisions affecting the company, and those which protect the value of its investment – e.g., changes to share capital, fundamental M&A, changes to the company' dividend policy, changes to key management and changes to the budget or business plan.

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?

Shareholder Level:

- **Enforceability**: Courts may choose not to enforce a contractual veto right under a shareholders' agreement if it is deemed to be against public policy or if it unreasonably restrains trade. Any such provisions should be drafted carefully considering Australian and common law principles.
- **Conflicting Interests**: Shareholder veto rights can lead to a deadlock. This can be addressed by including alternative dispute resolution provisions in the shareholders' agreement, such as mediation, arbitration, or the appointment of an independent expert.

Director Nominee Level:
- **Fiduciary Duties**: Directors must act in the best interests of the company and all of its shareholders. A governance protocol should be agreed by shareholders to monitor and ensure director nominees still act in the best interests of the company when exercising any veto rights. A nominee director is able to communicate and consult with the nominating shareholder and the shareholders' agreement typically provides for this.
- **Board Decision-Making**: Board decisions will usually require a majority of board members to agree. An individual director nominee will therefore rarely be able to unilaterally block decisions at board level. The nominating PE investor will often therefore instead rely on its contractual veto rights under the shareholders' agreement.
- **Conflicts of Interest** – see question 3.7 below.

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 (as shareholders) generally do not owe direct fiduciary duties to other shareholders, including management shareholders, and *vice versa*. However, there are certain situations where duties or responsibilities may arise:
- **Director Fiduciary Duties**: PE investor or management shareholder representatives appointed to the board, as directors, owe fiduciary duties to the company and must act in the best interests of the company as a whole, which includes considering the interests of all other shareholders.
- **Oppression Remedy**: Although it does not create a direct duty owed by the PE investor to minority shareholders, under the *Corporations Act 2001 (Cth)* ("**Corporations Act**"), minority shareholders can seek relief if the conduct of a company's affairs, including actions taken by majority shareholders, is oppressive, unfairly prejudicial, or unfairly discriminatory against them.
- **Shareholders' Agreement**: This outlines the rights and obligations of the shareholders, including *vis-à-vis* one another.

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)?

- **Governing Law and Jurisdiction**: While parties can contractually choose the law and jurisdiction, it is common for shareholders' agreements to be governed by the laws of the relevant Australian state or territory where the company is incorporated or has its principal place of business. This ensures compliance with mandatory local laws and regulations and simplifies dispute resolution.
- **Non-compete and non-solicit**: These provisions must not unreasonably restrain trade and must therefore (i) be reasonable, (ii) be designed to protect a legitimate business interest, and (iii) not be against public interest. Australian courts have the power to "read down" overly broad non-compete or non-solicitation provisions to make them enforceable.
- **Shareholders' agreements**: Shareholders' agreements must also comply with general principles of contract law, such as certainty of terms.

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 requirements include:
- a director must be at least 18 years' old and not be disqualified from managing a corporation due to bankruptcy or previous breaches of the Corporations Act;
- consent to act as a director, obtain a director identification number from the Australian Taxation Office ("**ATO**") prior to notifying the Australian Securities and Investments Commission ("**ASIC**") and subsequently notifying ASIC of the appointment; and
- compliance with directors' duties under the Corporations Act and common law.

Key potential risks and liabilities for:

(i) **Nominee directors**:
- **Breach of directors' duties**: can lead to civil and criminal penalties, compensation orders, and disqualification from managing corporations.
- **Insolvent trading**: directors may be personally liable for debts incurred by the company if they allow it to trade while insolvent. Liability for insolvent trading cannot be indemnified or insured against under Australian law.
- **Tax, environmental and occupational health and safety liabilities**: directors can be personally liable for certain liabilities (e.g., unpaid superannuation contributions and workplace incidents).

(ii) **PE investors that nominate directors to portfolio company boards**:
- **Shadow director liability**: PE investors who exercise significant control or influence over a company's board may be deemed a "shadow director" and be subject to the same duties and liabilities as a formally appointed director.

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 deal with conflicts of interest in compliance with the Corporations Act and common law fiduciary duties. Ways to address such conflicts include: (i) disclosure to the board and, in some cases, to shareholders; (ii) abstaining from voting; (iii) obtaining board approval of the conflict of interest; and (iv) establishing independent board committees.

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?

- **ACCC (Australian Competition and Consumer Commission) approval** – a notification to the ACCC

is voluntary with no minimum threshold requirements. An exemption will generally take the ACCC 21 days to consider and approve.

- **FIRB (Foreign Investment Review Board) approval** – FIRB generally has 30 days from the receipt of the relevant application fee to consider an application for clearance. This period is often extended by FIRB.
- **Due diligence** – PE investors are increasingly willing to incur more upfront time and cost to carry out extensive due diligence on potential investments, including most recently with respect to ESG, compliance and cybersecurity.

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

Notable recent trends in the Australian PE market include:

- increased use of warranty and indemnity insurance, often with limited residual seller liability;
- fewer conditions precedent to completion or walkaway rights in order to maximise deal certainty – usually limited to mandatory and suspensory regulatory approvals;
- increased use of earn-outs and deferred consideration to bridge valuation gaps or to mitigate prevailing market uncertainty and/or volatility (including by the use of convertible securities, where conversion ratios are contingent on performance criteria); and
- return to structures providing preferred equity with a liquidation preference, as a means of managing volatility and down-side risk.

5 Transaction Terms: Public Acquisitions

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

Public-to-private transactions involve much greater regulation, complex strategy and more variables impacting successful execution than private company transactions. Deal success and associated corporate reputations may be influenced by various factors, including the ability to secure a pre-acquisition interest and to secure exclusivity during due diligence.

PE transactions will generally be structured as a "friendly"/board-endorsed public takeover bid or scheme of arrangement. Schemes of arrangement can provide greater flexibility in deal structures and certainty of outcome; however, the process takes around four months (ignoring regulatory requirements). The scheme process facilitates the financing required and resulting security structures, as the outcome is all or nothing and, if required, a "whitewash" process can be undertaken as part of the acquisition process to enable assets of the target can be used as security for the acquisition funding. The cost, availability and terms of funding these transactions remain a challenge due to rising inflation and interest rates.

A "firm" indicative bid price is usually enough for a target board to grant access to due diligence. A PE sponsor can obtain exclusivity, but generally only for a short period to allow the PE sponsor to complete due diligence and finalise its bid documents (e.g., of up to four weeks).

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

Established deal protection mechanisms available to PE investors include:

- exclusivity undertakings by the target, including: (i) a "no-shop", "no-talk", "no due diligence" suite of clauses designed to stop interactions with rival bidders; and (ii) matching and notification rights (should a rival bid emerge);
- break fees (limited to 1% of equity value if payable by the target);
- accumulation of pre-bid stakes;
- obtaining a call option over the shares held by one or more existing shareholders of the target; and
- public shareholder intention statements, which seek to bind other shareholders to taking certain actions in relation to a PE sponsor's bid.

The target board will generally ensure it retains a "fiduciary carve-out" so it can pursue superior proposals should they arise. It may be possible for the PE investor to negotiate a reimbursement of a proportion of diligence costs incurred in that scenario.

PE acquirers should have an incisive deal strategy to respond effectively to shareholder activist tactics. This could include adopting a dual-track structure (i.e., proposing both a scheme of arrangement and a takeover bid concurrently) to prevent loss of momentum, deter the accumulation of blocking stakes and minimise interloper risk.

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 funds typically prefer locked-box consideration structures (i.e., the consideration is fixed pre-completion by reference to the target's most recent accounts, subject to protections around value leakage after that reference date), both on the sell-side and the buy-side. This is because PE funds tend to favour price certainty and simplicity over precision. There is therefore no post-completion adjustment or true-up of funds (as is the case with the US-style completion accounts consideration structure). In Australia, the locked-box structure is therefore becoming increasingly common on PE transactions, particularly exits.

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 typically offer a limited set of warranties in relation to title and capacity, solvency, share capital and compliance with laws. In buyer-friendly transactions, a buyer will ask for warranties relating to the information provided by the seller in the due diligence phase.

In addition to the above warranties, management sellers will provide an extensive suite of business warranties covering, e.g., financials, tax, assets and liabilities, IP, data protection, and disputes.

Warranties are given at signing and repeated at completion.

The sale agreement usually includes a general indemnity for any loss associated with a breach of warranty and a tax indemnity covering pre-completion tax liabilities. A buyer may also negotiate specific indemnities for any known issues identified in its diligence.

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?

- **Regulatory covenants**: to aid with obtaining the necessary regulatory approvals that are conditions to the transaction.
- **Gap controls**: undertaking not to carry out or consent to certain non-ordinary course actions being taken in respect of the target business between signing and closing.
- **No leakage indemnity** (where the transaction is a locked-box structure).
- **Non-compete covenants**: for up to five years following completion; however, in the case of a PE seller (as opposed to the management team), the scope of such non-compete will typically be narrower and more specific, and of a shorter duration.

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?

There has been significant increased use of buy-side W&I insurance on PE deals over recent years. The retention typically ranges from 0.5% to 1% of the deal value. Policy limits depend on the transaction size and parties' risk appetite, but usually range from 10% to 30% of the deal value.

Customary exclusions from the policy include known risks, fraud, purchase price adjustments and earn-outs, secondary tax liabilities, environmental liabilities, underfunded pension plans, and employee underpayments. The policy period is usually for up to seven years for title and capacity warranties and tax warranties and three years for other warranties.

Pricing is usually broken down into: (i) premium – usually 1% to 3% of the policy limit; (ii) underwriting fees – ranging from A$25,000 to A$50,000 or more for larger or more complex transactions; (iii) broker fees – ranging from 0.5% to 1.5% of the policy limit; and (iv) GST (10%).

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 will typically be limited to the purchase price (in the case of title and capacity warranties) or a percentage of the purchase price (in the case of business warranties or other undertakings – usually between 20% and 60%). Where W&I insurance is being taken out, the management team's residual liability (if any) can be capped at a much lower amount. The business warranties will also be subject to disclosure prior to signing, but not between signing and completion.

Liability under a no leakage indemnity, tax indemnity or specific indemnity will typically not be capped. A *de minimis* and basket on claims (other than in relation to fundamental warranties, leakage claims or indemnities) are common, ranging between 0.05% to 0.1% and 0.5% to 1% of enterprise value, respectively.

Time limitations on claims will typically be seven years for fundamental and tax warranties, 24–36 months for business warranties, and three to 12 months for leakage warranties.

No limitations will apply in the case of fraud.

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

It is not uncommon for PE sellers to provide security for warranties and liabilities, depending on their relative bargaining power and perceived risks associated with the transaction. The most common type of security provided is a holdback of part of the purchase price (usually 10–25%), typically pursuant to escrow arrangements. Sponsor guarantees are uncommon and, if ever given, will be limited in scope (for example, in favour of the lenders).

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.)?

Debt finance – PE buyers typically provide financing letters or term sheets from their lenders as evidence that they have secured debt financing for the transaction. Failure to complete due to the inability to secure debt financing will give rise to a damages claim by the seller against the buying entity under the sale agreement. In rarer cases (where there is a high financing risk and/or on a competitive sale process), the PE seller may agree to paying a break fee in that scenario.

Equity finance – PE buyers often provide equity commitment letters from their fund or investors whereby the funds undertake to provide the necessary equity financing for the transaction. The letters are typically addressed to the buying entity and not the sellers directly, meaning in the event of a breach the seller's recourse will be limited to the remedies available under the sale agreement against the buying entity (e.g., a damages claim or seeking specific performance).

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

Reverse break fees are not common in PE transactions, especially compared to public M&A transactions. If employed, the trigger events will typically be limited (e.g., only if the buyer is unable to obtain financing or obtain the necessary regulatory approvals), and the fee amount will be a percentage of the transaction value. The reverse break fee will usually be stipulated to be the buyer's exclusive remedy under the sale agreement.

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 a PE seller may face include:

- An IPO may not immediately lead to a full exit of the PE seller's interest in the portfolio company. Depending on the circumstances, a PE shareholder may need to retain a stake and be subject to market risk and escrow restrictions (see question 7.2 below). Shares subject to voluntary escrow are not counted towards the minimum 20% free float required for admission to the ASX.

- A PE seller's ongoing interests and any associated transactions or arrangements will be subject to prospectus disclosure and public scrutiny.
- Volatility in market conditions can create significant risk to a successful exit through an IPO. There exist certain "windows" in market conditions where sponsoring brokers/underwriters will support floats to occur, and so timing a business to be ready for exit in a manner that aligns with an ECM window can be difficult.
- Heightened regulatory scrutiny may create greater uncertainty on the IPO exit.
- Ensuring adequate insurances are in place to help mitigate IPO risks is vital (e.g., D&O cover).
- Pricing and post IPO share price performance are key reputational matters for sponsors.

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

PE sellers may be subject to escrow arrangements that are ASX imposed or voluntarily agreed with the company (to make the IPO more attractive to investors). Voluntary escrow may be required by underwriters or sponsoring brokers as a condition to their involvement in the IPO.

If shares are subject to mandatory escrow, restriction agreements are signed by the shareholder, subject to an escrow period of up to 24 months from the date of quotation. The terms and period of escrow under voluntary escrow arrangements are negotiated between the relevant parties.

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 utilised by PE sellers with the aim of maintaining competitive tensions and maximising the exit price for their investment, and because it is difficult to predict whether the IPO "window" will be open when it is ready to launch. The final exit route will then depend on market volatility and other circumstances but is more commonly through a private sale process where valuations are acceptable and to avoid the risks and uncertainty associated with launching an IPO process.

How long PE sellers continue to run a dual-track exit process will depend on the point at which the PE seller receives an acceptable private offer. The dual-track process and timetable will be structured for tactical considerations and to co-ordinate specific milestones, and typically end upon signing a sale agreement with the selected purchaser or an IPO underwriting agreement with the underwriter/sponsoring broker.

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 (including the syndicated loan market, private credit market and the high-yield bond market).

The most common sources of debt finance used to fund PE transactions in Australia are the international and domestic banks and, more recently, private credit, non-bank and institutional lenders.

Acquisition financing packages traditionally feature an amortising term loan A, bullet term loan B, a revolving facility (for working capital) and sometimes as needed, capital expenditure/acquisition facilities. Where loans are of a sufficient size, they will most commonly be provided by a syndicate of financiers. The syndicated loan market reached a new high in 2022 with $140 billion in loans, as Australian sponsors relied significantly more on syndicated loans than corporate bond issuances.

On larger acquisition financing packages, mezzanine loans are often also included, with a trend for that mezzanine funding to be at a level higher than the borrower or obligor group for the senior loans.

The private credit market has also become a vital source of debt financing due to its flexibility and customisation, with loans from private lenders often providing greater quantum and more flexible terms than the syndicated bank market. The growth of private credit has also given rise to other forms of financing packages, with unitranche loans (being a hybrid of a senior and subordinated loan as a single loan) increasing in popularity. Increased demand has resulted in alternative lenders, institutional investors and credit funds allocating capital to private debt strategies and contributing to growth in the acquisition financing market.

While corporate bond issuances are also available to finance PE transactions (primarily through international high-yield markets), they remain a small proportion of the financing packages used by Australian sponsors and companies for acquisition financings.

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?

Relevant legal requirements or restrictions include:

- the general prohibition under the Corporations Act on companies providing financial assistance for acquiring their own shares or shares in a holding company, subject to specific exceptions (e.g., if it does not materially prejudice the company's interests, is part of an employee share scheme, or is provided by a company without subsidiaries and not a holding company);
- the Australian Foreign Acquisitions and Takeovers Act 1975 (Cth), which regulates the making of investments by foreign persons in Australian companies and assets. In particular, the provisions can impact the security package (particularly where it involves real property) and the identity of the lending entity; and
- Australia's insolvency regime (including *ipso facto* provisions), "administration risk" and corporate benefit requirements.

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

We anticipate economic headwinds that will continue to impact the leveraged finance market over the next 12 months, and tighter lending conditions from major banks.

The growing prominence of ESG factors coincides with the rise of sustainability-linked loans, where borrowers are incentivised to achieve predetermined ESG-related targets for improved pricing or other benefits. See question 8.1 above for other notable recent trends.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

Continuation fund deals have become more prevalent in Australia over the last 12 months, following long-term trends in Europe and the US. Secondary transactions led by general partners have become an integral feature of Australia's secondaries market, representing almost half of all secondary transactions. Now that some of the largest domestic PE firms (as well as international PE firms) have successfully implemented such transactions in Australia, we expect familiarity with and the use of such vehicles to significantly increase in the market in the short to medium term.

9.2 Are there any particular legal requirements or restrictions impacting their use?

There are no specific legal requirements or restrictions that directly impact their use in Australia. However, their use will indirectly be impacted by: (i) regulations under the Corporations Act (regarding reporting, disclosure and fiduciary duties); and (ii) provisions under the relevant fund constitutions or limited partnership agreements, e.g., specific approval requirements and dealing with conflicts of interest.

10 Tax Matters

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

The tax treatment of payments from an investee company to the investor will depend on whether the investment has been made by way of debt or equity:

- In the case of equity, dividends sourced from Australian profits that have been subject to tax in Australia can generally be franked (i.e., sourced only from profits that have been subject to tax) such that no dividend withholding tax applies on the payment of that dividend to a shareholder that is a non-resident of Australia.
- Where the investment is structured as debt, assuming the debt deductions are not denied (e.g., under the applicable thin capitalisation, transfer pricing and anti-hybrid rules), the tax rate would be limited to interest withholding tax of 10% (subject to any relevant tax treaty).

Off-shore structures are relatively common as capital gains and losses made by a non-resident are not assessable where the disposal does not relate to taxable Australian property.

However, the ATO generally considers the disposal of investments by PE investors to be on revenue account. Where this is the case, a key consideration is whether the gain made on disposal has an Australian source. Where a tax treaty applies, usually the gain will only be taxable in Australia where it is derived through a permanent establishment that the investor has in Australia.

Depending on the assets held by an investee company, an Australian buying entity may be attractive as it may be possible to elect to form an income tax consolidated group and reset the tax cost bases of certain underlying assets, which may give rise to additional depreciation deductions or provide benefits in the context of a future asset sale.

There are also several common investment structures used in PE that may provide additional flexibility or tax concessions (e.g., unit trusts or venture capital limited partnerships).

10.2 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 Australia, management teams are commonly incentivised through an "employee share scheme", which provides for the issue of shares or options to acquire shares in a target entity.

While participants in an "employee share scheme" are generally taxed on revenue account on the discount to market value of their options or shares, where certain conditions are met the tax liability may be deferred to a later date. Generally, the income tax consequences are borne by the participant and no withholding applies.

Other structures such as "loan funded shares" or "premium priced options" are commonly used in PE as, where structured correctly, the "employee share scheme" rules should not apply to those interests, and those interests will be held on capital account.

Phantom equity is not commonly used in Australia, as payments under a phantom equity plan are generally treated as salary and wages and have associated withholding and superannuation obligations.

10.3 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 who are rolling over into a new structure will be whether capital gains tax "rollover relief" (for example, "scrip for scrip rollover relief") is available. Where the conditions for "rollover relief" are met, managers can defer paying tax on the disposal of their interest in the original entity until they dispose of the interest received in the new structure.

Where the interests held by managers are subject to the Australian "employee share scheme" rules, additional specific "rollover relief" provisions, which are more prescriptive than the usual "scrip for scrip" conditions, can apply.

Managers will want to ensure the transaction does not inadvertently trigger an unfunded Australian tax liability for managers, particularly where there is no cash component to the rollover available to fund any such liability.

Where managers sell their interests and do not reinvest into a new structure, relevant Australian tax considerations include whether the gain is taxable on capital or revenue account, and whether a capital gains tax discount is available (for interests held by Australian residents, the taxable gain can be reduced by up to 50% where an interest has been held in an individual capacity for at least 12 months).

10.4 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?

Significant changes are proposed to be made to Australia's thin capitalisation rules. If implemented, the new measures will apply (with retrospective effect) to income years commencing on or after 1 July 2023 and broadly:

- limit an entity's net debt deductions to 30% of its tax BITDA. Any denied deductions under this new test can be carried forward subject to a carry forward regime;

- allow debt deductions where those deductions relate to expenditure attributable to genuine third-party debt, subject to satisfying certain conditions;
- allow an entity in a group to claim debt-related deductions up to the level of the worldwide group's net third-party interest expense as a share of earnings; and
- disallow deductions of an entity that are incurred in relation to a "debt creation scheme".

In June 2018, the ATO issued guidance in relation to the corporate tax residency tests such that a foreign incorporated company that has its Central Management and Control in Australia is considered to be an Australian tax resident, even if it does not carry on any other business in Australia. The transitional period ends on 30 June 2023, following which ATO compliance activity in respect of foreign incorporated entities with Australian management is likely to increase.

Other recent measures that may impact the PE industry include:

- the hybrid mismatch rules that apply from 1 January 2019;
- the announcement of a 15% global minimum tax and domestic minimum tax, intended to apply for income years starting on or after 1 January 2024; and
- the announcement of a specific measure to prevent a company from attaching franking credits to distributions made outside of the company's normal dividend cycle, where the distributions are funded by a capital raising that results in the issue of new shares, to apply from 15 September 2022.

11 Legal and Regulatory Matters

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

Yes, the most significant recent developments relate to the expansion of Australia's foreign investment review regime and the transactions that have become subject to it, including:

- the introduction of a new national security test, the concepts of "national security business" and "national security land" and the call in and last resort powers for the Australian Treasurer (January 2021);
- expansion of the definitions of "critical infrastructure asset" and "national security business" and, in turn, the scope of transactions requiring FIRB approval (December 2021);
- changes to the threshold interest in an Australian media business that requires mandatory approval (first half of 2022);
- the doubling of filing fees for applications for foreign investment approval, increasing the maximum fee payable for a single action from A$522,500 to A$1,045,000 (July 2022); and
- the indexing of the monetary screening thresholds on 1 January 2023 (as done on 1 January of each year).

Anticipated developments include:

- increased reporting obligations for foreign persons on or after 1 July 2023 by notification to the ATO of certain events (whether or not such events are subject to FIRB approval) in connection with the proposed new Register of Foreign Ownership of Australian Assets; and
- the Treasury's increased focus on non-compliance by foreign persons with their statutory reporting obligations that may result in the increased issue of infringement notices and pursuit of civil penalties for contraventions.

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

Yes, foreign investment approval to transactions will be required for PE investors who are:

- "private foreign investors";
- "foreign government investors";
- investing in a "national security business" or in a "national security land", regardless of the value of the relevant asset; and/or
- investing in certain other businesses (e.g., an "Australian Media Business" or land transactions of different categories), subject to a range of specific thresholds and approval requirements.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

There are no additional legal/regulatory requirements that apply specifically to impact investments as yet. However, the following general regulations may be relevant to impact investments:

- green and social washing can result in Australian regulators pursuing pecuniary penalties and/or strategic litigants bringing a claim against a portfolio company for misleading or deceptive conduct;
- the Australian Financial Services Licensing ("**AFSL**") provisions in the Corporations Act can be relevant to the issue of and dealing in impact investments that constitute "financial products", which may require the obtaining of a licence or use of licensed advisors in relation to an issue of an impact investment. Issues are often structured as offers to sophisticated or wholesale investors to avoid the higher regulatory burdens associated with retail issues; and
- structuring sustainability-themed or impact-labelled financial products will require adherence to relevant design, disclosure and assurance frameworks, such as Global Impact Investing Network ("**GIIN**") or the IFC's Operating Principles for Impact Management.

The Australian Federal Government has also committed to introduce standardised, internationally aligned reporting requirements for businesses to make disclosures regarding climate-related governance, strategy, risk management, targets and metrics. The key requirements, timing and consequences of non-compliance are yet to be confirmed by Treasury.

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

The level of due diligence conducted by PE investors in Australia is usually comprehensive and undertaken by external advisers, comprising reporting on legal, tax, financial/accounting, technical, commercial, IT systems, cyber, business risk and (increasingly) ESG. Due diligence investigations commonly last between 30 and 60 days. On competitive processes, the timespan is much shorter and dictated by bid deadlines.

The scope of legal due diligence in Australia will commonly cover:

- group structure and share/asset ownership;
- financial obligations/liabilities and security;
- key terms of material contracts and employment contracts, and compliance with superannuation obligations;

- real property;
- intellectual property;
- IT, cybersecurity and data privacy;
- material litigation; and
- regulatory and compliance.

Diligence will almost always be conducted on a "red flag" or "exceptions only" basis. Materiality thresholds can be quantitative (set by reference to a percentage of the target's annual revenue or EBITDA) as well as qualitative (otherwise likely to impact on the target's operations or reputation, or the PE investor's decision to proceed with the transaction). Where W&I insurance is being taken out, quantitative materiality thresholds are typically set to be in line with the proposed *de minimis* on claims under the policy.

11.5 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.)?

Each of Australia's jurisdictions has anti-corruption legislation under statute and common law that address bribery and corruption. It is therefore common for PE investors to require warranties in sale agreements covering bribery and corruption-related risk. PE investors will also often conduct due diligence investigations to identify any issues and/or the policies and procedures that a target entity has in place to ensure its officers or employees do not engage in bribery or corruption, and how any identified issues are addressed. The level of due diligence investigations conducted will vary depending on the nature and of the business and how likely the risk of bribery and corruption is in the target's industry and geography.

11.6 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?

(i) In general, shareholders are not liable for the liabilities of the company to which their shares relate. However:
- courts may "pierce the corporate veil" where there has been fraud or improper conduct, e.g., a company is established as a sham and not for trading purposes, but to avoid fulfilling its legal obligations;
- PE investors may be subject to certain environmental and tax liabilities, if they have contributed to or been involved in such breaches and/or tax avoidance; and
- PE investors may be liable for insolvent trading by a company if they have breached their duties as directors and/or allowed the company to trade while insolvent.

(ii) In general, one portfolio company cannot be held liable for the liabilities of another portfolio company, as each company operates as a separate legal entity with limited liability. However, there are limited (and rare) exceptions to this:
- piercing the corporate veil, certain environmental liabilities and occupational health and safety matters, and insolvent trading (see point (i) above);
- cross-guarantees between portfolio companies;
- joint ventures or partnerships entered into between one or more portfolio companies; and
- it is common for wholly owned Australian portfolio companies to form a consolidated group for tax purposes; therefore, each member is liable for each other member's tax liability by virtue of being a member of the consolidated group.

12 Other Useful Facts

12.1 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?

Overall, Australia's stable political and economic environment, strong financial sector, rich natural resources, proximity to Asia, and diversified economy make it an attractive market for investors looking for stable and long-term investment opportunities across numerous asset classes such as healthcare, mining, finance, technology property, and infrastructure. Australia also has strong trade and investment links with the rest of the Asia-Pacific region, and its close ties with countries such as China and Japan have led to significant investment flows.

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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 (deal values of EUR 100 million and above) the main trend over the last few 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, 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, debt funds have become increasingly active over the last years, offering a wide array of instruments, ranging from growth capital, stressed financing, and 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 the CEE markets maturing, we have seen this becoming a lesser issue over the last couple of years for most funds. However, due to the latest political uncertainties and the war in Ukraine there is a change in momentum and investors are putting more emphasis on country risk and potential related sanctions.

1.3 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 in 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 entrepreneurial families only. The main difference to traditional private equity is their evergreen structure, which allows them to remain invested for the long term and puts less focus on drag and 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 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 structural subordination.

Private equity funds will usually try to maximise debt in the financing structure for a transaction. The difference between available 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, debt-to-equity ratios of 3:1 to 4:1 are generally accepted.

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 that 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. Transactions violating financial assistance rules, on the other hand, are not void but may result in the 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 onshore tax groups and structural subordination of junior lenders (see above). Any Austrian HoldCos and BidCos can enter into a tax group with the target company allowing for a set-off of interest expenses at the HoldCo (or BidCo) levels with the taxable profits of the target company (for a more detailed discussion, please see questions 10.1 and 10.4).

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. The types of available minority protections differ, 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 and tax 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 refer 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 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, relocation). Attaining retirement age, death or permanent incapacity or disability are typically seen as good leaver case.

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, D&O 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 or exit waterfall, 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 initial public offering ("IPO") or a shotgun mechanism) as well as reporting, information and access rights. On platform deals, it is also important to secure that the decision on if and when acquisitions are made rests with the fund and that this cannot be blocked by the other shareholders.

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

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 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 or advisory 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 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).

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 are hardly ever 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 breach of anti-bribery legislation (see question 11.5).

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 concerning 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 I proceedings (if no exemption is granted) and up to five months if cleared in Phase II 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 advance 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 advance approval (depending on state law)).
- Foreign direct investment ("FDI") clearance (please see the discussion under question 11.1 for further details).
- FSR clearance (please see the discussion under question 11.1 for further details).

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 (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 employed in most deals, particularly where investors are sellers.

Dedicated debt funds (see question 1.1) have become increasingly relevant.

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. The 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 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 itself 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?

Seller policies (which protect the seller from its own innocent misrepresentation) are sometimes used but this is fairly uncommon. Buy-side policies (which protect the buyer from the seller's misrepresentation (innocent or otherwise)) or flipping policies (that is a policy organised by the seller as part of the auction process that flips into a buyer's policy) are more common, particularly in auctions.

The typical excess is around 1% of the policy limit. 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: three to 10 years;
  - business warranties: 12 to 24 months;
  - tax warranties: relative (three to six months plus) or fixed at seven years; and
  - environmental warranties: five to 10 years.
- Financial limits, including:
  - a cap on the total liability and a sub-cap for warranty claims;
  - an aggregate claims threshold ("basket" or "deductible"); and
  - an exclusion of *de minimis* claims.
- Limitation to direct loss (as opposed to indirect and consequential loss).
- 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, 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 (including the syndicated loan market, private credit market and the high-yield bond market).

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. In mid- and small-cap transactions, there is usually just one single term loan facility, a working capital facility and the institutional debt from the fund. In large-cap transactions, there are usually more term loan facilities with different repayment profiles, a working capital facility and the institutional debt from the fund. Where time is of relevance and the cost benefit is outweighed by increased complexity, funds have in the past employed unitranche facilities. Due to the increase of interest rates, there has been a shift towards more traditional structures for total cost reasons. High yield only plays a role in the large-cap segment or post-completion refinancing.

Overall, the financing environment remains difficult and resilience against political risk, interest rate changes and supply chain issues are a top priority for lending desks, which makes it difficult if not impossible to raise debt in certain segments. Healthcare and tech transactions usually can be financed, albeit not at the same terms as in 2021. In general, banks are still very cautious, resulting in a shift towards private 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. Private debt funds managed by a licensed AIFM 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 in question 8.1.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

Most transactions are primary transactions.

The increased use of continuation vehicles and secondary transactions has, however, given rise to additional discussions related to transfer restrictions and Drag and Exit clauses in the shareholders' agreement as funds want to reserve that exit route while other shareholders tend to have concerns related to the arms'-length nature of the transaction and the impact on their own exit timeline.

9.2 Are there any particular legal requirements or restrictions impacting their use?

There are no particular legal requirements or restrictions.

10 Tax Matters

10.1 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 the Austrian BidCo level with profit generated at the target company level (however, see question 10.4 regarding the interest limitation rule). 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 the 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, such disclosure rule may be burdensome to comply with in relation to funds acting as lenders.

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.

10.2 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).

10.3 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.

10.4 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?

Corporate income tax rate

As part of the "eco-social" tax reform package, the corporate income tax rate dropped from 25% to 24% for FY 2023 and will drop to 23% for FY 2024 and subsequent years. Tax incentives for certain ecological investments have also been introduced.

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.

Interest limitation rule

As of 2021, Austria has implemented an interest limitation rule in order to comply with the EU Anti-Tax-Avoidance Directive ("ATAD"). The purpose of the interest limitation rule is to limit the deductibility of loan costs depending on the company's earnings before interest, tax, depreciation and amortisation ("EBITDA") if the debt leverage is higher in Austria than the average of the whole group. The deductibility of interest surplus (*Zinsüberhang*) is, in principle, limited to 30% of the tax EBITDA of the respective year. In the case of a tax group, the aforementioned generally applies at the level of the group head. There are four significant exceptions to the interest limitation rule:

- Up to EUR 3 million of interest surplus is fully deductible. The amount exceeding this sum is subject to the interest limitation rule. In the case of a tax group, the allowance applies to the entire group, not per group member.
- The interest limitation rule does not apply to standalone entities. A standalone entity is considered an entity, which is not (fully) included in consolidated financial statements, has no affiliated companies, and has no foreign permanent establishments.
- The interest surplus can be fully deducted if the company can prove that the ratio of its equity over its total assets is equal to or higher than the equivalent ratio of the corporate group it belongs to (equity-escape clause). A two-percentage points tolerance exists.
- For contracts concluded before 17 June 2016, the interest limitation rule is not applicable until 2025.

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 a 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 circumvention of the reporting obligation under the Common Reporting Standard or 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 must be analysed whether such new reporting regime applies or not.

11 Legal and Regulatory Matters

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

FDI – clearance

In July 2020, the Investment Control Act ("ICA") came into force, which requires advance clearance for certain FDIs by investors from outside the European Economic Area ("EEA") or Switzerland. Direct and indirect acquisitions of:

- voting rights of 25% or 50% (in critical sectors 10%);
- decisive influence in an Austrian company; or
- significant assets,

in sensitive sectors such as defence, energy, digital infrastructure, R&D, but also IT, public transport, health, telecommunications, chemicals, robotics, semiconductors, nuclear technology, biotechnology, food supply, supply of pharmaceuticals, vaccines, medicinal products and media, which are considered to be of critical importance, require advance clearance by the Austrian Ministry of Digital and Economic Affairs.

Exempt from the approval requirement are FDIs in micro-enterprises, including start-ups with less than 10 employees and an annual turnover or balance sheet total of less than EUR 2 million. Approval may be granted subject to 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 is granted. Proceedings take between two-and-a-half months (in simple cases) and five to six months (in more complex cases). Clearance certificates can be applied for but are only advisable for clearcut cases. They are generally issued quickly.

FSR – clearance

On 12 January 2023, the Foreign Subsidies Regulation (EU) 2022/2560 ("FSR") came into force to address distortions of competition caused by third-country subsidies in the EU's internal market. In July 2023, a regulation is due that will provide further guidance on the application and interpretation of the FSR. Under the new rules, transactions must be notified to and cleared by the European Commission if:

- either (a) at least one of two (previously independent) merging undertakings, (b) the acquired undertaking, or (c) a JV to be formed is established in the EU and has achieved an EU turnover of at least EUR 500 million in the last business year; and
- either (a) the acquiring undertaking and the acquired undertaking, (b) the merging undertakings, or (c) the created JV and the undertakings creating the JV have received so called foreign financial contributions ("FFC") (that is, financial contributions from non-EU governments) in the last three years prior to the transaction. FFC is construed broadly and does not only comprise financial assistance (e.g. (capital injections, loans, guarantees, etc), but also other types of assistance (e.g. tax reliefs).

Phase I proceedings take 25 working days from filing. If Phase II proceedings are initiated, there is an additional review period of 90 working days. Clearance may be granted subject to conditions. If the transaction is prohibited, it may not be implemented.

11.2 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 11.1. 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).

11.3 Are impact investments subject to any additional legal or regulatory requirements?

There is no regulation specific to Austria.

11.4 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.

11.5 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.

11.6 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.

12 Other Useful Facts

12.1 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 the recent past it was sometimes difficult for private equity investors to access Austrian businesses, particularly where the business is family owned. That has changed as the market matured and well-advised sellers meanwhile consider private equity as a viable and often very attractive option for an exit. Still, due to the increased complexity it is important to have the right advisory teams on both sides of the table.

Investors should also be aware that the Austrian Ministry of Digital and Economic Affairs is taking a rather strict approach when it comes to FDIs by non-EEA/non-Swiss investors in sectors qualifying under the ICA (see question 11.1) and typically requires the transaction to be notified. Clearance typically takes approximately three months, which must be taken into account in the overall timing. Notifications can be made on the basis of preliminary documentation (e.g. a term sheet).

In relation to listed target companies, investors should be aware that there is often limited free float and one or two major controlling block shareholders.

Florian Philipp Cvak's practice focuses on corporate and corporate finance work with a particular focus on private equity, venture capital, M&A, mezzanine and LBO financings. Furthermore, he specialises in US lease and project finance transactions. His practice is complemented by Restructuring, General Corporate and Contracts work.

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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 in the Austrian market and is particularly appreciated by financial sponsors. The firm usually acts for financial sponsors, but also advises banks on LBO 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?

Although private equity and venture capital funds have operated in Brazil since the 1980s, this industry experienced a significant development after 1994, and exponential growth over the last decade, resulting in a more sophisticated market. An important landmark for the industry was the creation of the Fundo de Investimento em Participações (FIP) in 2003, which is the main vehicle used by private funds to present day.

Private equity investors adopt different investment strategies and may seek a controlling or significant minority stake in the portfolio companies. In both cases, due to regulatory requirements applicable to FIPs, private equity funds need to exercise effective influence over the invested companies.

In addition, private equity investors may choose to make the investment as a leveraged buy-out or to use a fully funded strategy. The first alternative is used when the vehicle used by the investor contracts a debt to pay the purchase price, and such debt is compensated with the growth generated by the enterprise. The fully funded strategy is used when the investor raises funds prior to structuring the investment. As described below, a leveraged buy-out may only happen when the private equity company structures a holding company, as FIPs are not allowed to incur in debt before financial institutions.

In relation to the size of the companies involved in the transactions, most private equity investments are directed to the middle market, in sectors with good consolidation perspectives. Transactions involving larger companies are not uncommon, but these deals are usually divestments of the private equity investors.

In terms of the divestment strategy, private equity investors will either perform a strategic M&A or initial public offering (IPO). The most common divestment strategy used by the private equity investor in Brazil is to enter into an M&A transaction with a relevant and strategic player in the sector of the company. Although the number of IPOs increased in recent years, particularly due to capital markets becoming more attractive due to low interest rates, M&As are still the main divestment strategy of private equity investors.

The industries that generated the most private equity deals, both in value and in number, are the following: agribusiness; education; healthcare/life sciences; industrial facilities; technology; telecom; financial services; and renewable energy.

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

Private equity fundraising experienced a year-on-year increase in Brazil, which we believe to be due the following reasons: (i) the main sectors invested by private equity in Brazil are resilient to such factors and the economic crisis; (ii) the Brazilian currency has depreciated *vis-à-vis* the US Dollar; (iii) Brazil improved the laws and regulatory framework, being more attractive to private equity and venture capital investments; and (iv) Brazil inflation is under control and a reduction of interest rates is expected.

1.3 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 respective high return rates in the long term have attracted different types of investors to diversify their portfolio with the inclusion of private equity investments. This might be difficult for the public as only qualified or professional investors' FIP structures are allowed to invest in such funds. However, we are seeing an increase in high-net-worth individuals making private equity investments through family offices. In some cases, when the family office has a more sophisticated structure with qualified managers, it may also directly invest in a private equity transaction.

The main difference between more traditional firms and such investors usually relates to the level of intervention in the company's governance. Private equity funds will usually demand more veto rights and be directly involved in the daily management of the company. Family offices will usually use the private equity investments as a part of its diversification strategy, in which the main concern is having a positive return on the investment.

2 Structuring Matters

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

Due to tax efficiencies, private equity investors in Brazil usually adopt a structure that involves FIPs. The acquisition structure for private equity transactions is usually the acquisition of shares. Notwithstanding, more complex structures are being adopted by private equity, for example: (i) mezzanine capital involving subordinated debt arrangements; and (ii) private investment in public equity (PIPE), which involves the investment of private equity vehicles in publicly traded corporations.

2.2 What are the main drivers for these acquisition structures?

The main driver for choosing the FIP as the investment vehicle is tax efficiency. FIPs are exempt from income tax, and, therefore, income and gains deriving from the portfolio of FIP assets are not subject to taxation at FIP level. Although profit distributions carried out by FIPs are subject to withholding income tax at a 15% rate, non-resident investors investing in Brazilian financial and capital markets are subject to WHT at a zero rate if certain requirements are met.

It is also important to mention the recent Economic Freedom Act enacted by the Brazilian Congress in 2019. Among other important minimal government intervention rules and principles, such law implemented relevant changes to investment funds. According to the Economic Freedom Act, the Brazilian investment funds may (i) limit investors' liability to their capital, (ii) limit the administrators' and advisors' liabilities to their own acts, and (iii) create different classes of shares with different rights.

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

In general, private equity sponsors organise FIPs and carry out fundraising, acting as managers of the fund. After that, FIPs acquire stocks of the portfolio companies.

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

When the private equity investor takes a minority position, it generally requires affirmative votes or veto rights on the most relevant corporate, finance, business, and employee decisions. Such rights can be derived from a necessary affirmative vote from a specific class of shares held by minority investors, or a provision that specifies that a certain director appointed by the minority investor must approve such matter, or a certain percentage of the company.

Private equity investor usually prioritises the need of shareholders' approval, instead of directors' approvals since the bylaws and the shareholders' agreement will provide for such matters and the chairman of the meeting shall not accept any vote in conflict with the shareholders' agreement. In addition, the director (even if appointed by a certain shareholder) owes fiduciary duties to the company, not the shareholders. Minority investors' rights can either be limited to the most relevant matters (e.g., a sale of controlled companies or changes to its bylaws), or extend to broader operational issues (e.g., incurring debt or the capital expenditures above certain thresholds). A private equity fund may negotiate its rights depending on the fund investment strategy, its confidence on the other shareholders of the target company, its investors' expectations, and the expertise of the general partner.

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?

Many companies create employee incentive programmes for the strategic management members. The most common types of programmes used are stock options, phantom shares, and partnerships. The amount of equity directed to these programmes is usually in the range of 10–20%, varying according to the current stage of the company. It is also common to include cliff, vesting, compulsory sale, cancellation of unvested options/equity and other customary provisions. The vesting is usually based on the time that the manager remains in the company, but it is not unusual to see it based on the achievement of certain performance targets. In addition, if the beneficiary of such programme leaves the company, the company usually has a call option to acquire the stock, which is subject to good leaver and bad leaver provisions.

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 means leaving employment on grounds of involuntary dismissal, mutual agreement, death, or disability. On the other hand, bad leaver usually means leaving employment due to voluntary resignation or dismissal with cause.

3 Governance Matters

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

Prior to private equity investments (or other type of relevant investment), Brazilian companies usually do not have sophisticated governance mechanisms, being managed mostly by the controlling shareholders and the officers, which are appointed directly by the controlling shareholders.

Private Equity funds generally require the enhancement of target's governance, including the creation of a Board of Directors, which is responsible for: (i) establishing the general orientation of the company's business; (ii) electing and dismissing the officers of the company and establishing their attributions; or (iii) supervising the management of the company by the officers. In addition, it is not uncommon for Private Equity funds to nominate the CFO of the target.

In addition, Private Equity funds require certain modifications to the governance of the target to comply with regulatory requirements established by the Brazilian Securities Commission (CVM) and self-regulatory organisations such as ANBIMA, which requires: (i) the private equity fund to effectively influence the management of the companies; (ii) the Board of Directors to have a unified two-year term of office; (iii) disclosure of related party transactions and approval of such transactions by

the private equity fund's shareholders; (iv) independent audit of the financial statements; and (v) settlement of corporate disputes through arbitration chambers.

Documents such as the bylaws or the articles of incorporation of the portfolio companies, as well as the reference form and internal policies of the general partner, are publicly available. Nonetheless, the most relevant document for the governance of the portfolio company, which is the shareholders' agreement, is not publicly available and it is generally subject to 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?

Private equity investors and the nominated directors typically enjoy veto rights over major corporate actions, which are usually provided by the shareholders' agreement. Other than the examples mentioned above, the vetoes usually include: (i) capital increase or issuance of convertible instruments, which may cause dilution of the investor; (ii) contracting loans or providing guarantee in financial transaction above a certain threshold; (iii) sale or acquisition of material assets, including the sale of all or substantially all assets of the company; and (iv) appointment of key managers.

The vetoes mentioned above are common in cases where the investors take a minority position to protect the investment; however, such vetoes may vary depending on the amount of stake acquired by the private equity investor.

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

Brazilian law does not create any specific limitation to veto arrangements at shareholders' and/or directors' level. The shareholders' agreement is binding in relation to both shareholders' and directors' decisions and resolutions, and, in the case of someone deciding to vote in disagreement with the shareholders' agreement, the chairman of the meeting shall disregard the vote.

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 accordance with the Brazilian Corporation Law, where the private equity investor is a controlling shareholder, it shall use its controlling power to fulfil the corporate purpose of the company. The Brazilian Corporation Law also provides that controlling shareholders owe fiduciary duties towards minority shareholders, the company's employees and other stakeholders and is liable for abusive use of its controlling power.

Furthermore, in accordance with the Brazilian Corporation Law, all shareholders, regardless of the amount of stake, must exercise their voting rights in the company's best interest, as opposed to voting only with considerations to their own interests; such vote would otherwise be considered abusive. Any shareholder may be liable for damages caused by an abusive vote, even if its vote does not prevail.

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 specific limitations or restrictions to the contents or enforceability of shareholders' agreements in Brazil, provided that such agreements do not violate Brazilian national sovereignty, public policy and good morals/ethics and do not violate structural traits of each type of company (e.g., joint-stock companies cannot distribute profits disproportionate to the equity holdings of each shareholder).

Nonetheless, non-compete provisions are limited by Brazilian antitrust law and labour law, depending on the scope of the non-compete.

In addition, shareholders' agreements without a term of effectiveness may be terminated at any time by either party with reasonable prior notice. Brazilian case law also holds that agreement with an unreasonable long term of effectiveness should be treated as agreement without a term of effectiveness and may be terminated anytime.

Although shareholders' agreements of Brazilian companies may be governed by foreign law and subject to foreign jurisdiction, this is unusual, given Brazilian law particularities and the requirements to enforce foreign decisions in Brazil.

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?

Brazilian corporate law states that individuals who are impaired by special laws or have committed certain crimes that would preclude such individual of accessing public offices, cannot be elected as officers or directors. Foreign individuals are eligible to be appointed as directors and officers if they appoint a Brazilian resident as an attorney-in-fact.

Directors are, in general, not liable for debts of the company, except if the director acted beyond the powers provided to them (*ultra vires*) and/or in violation of fiduciary duties.

Private equity investors that nominate directors to the board of portfolio companies are not subject to any responsibility in such regard, being subject to the usual responsibilities of shareholders.

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

The directors shall act in the company's interest, regardless of the shareholder who appointed them. Accordingly, the directors are not allowed to protect the interest of certain shareholders in detriment of the company's interests and cannot vote in resolutions in which they have a conflict of interest.

The director may hold position in other portfolio companies, provided that such companies are not competitors. If the companies are competitors, the shareholders should expressly allow the director to hold such positions.

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?

Private equity transactions may be subject to certain approvals that might impact the foreseen timetable, such as: (i) antitrust clearance; and (ii) approval of regulators, such as the Central Bank of Brazil for financial institutions, Private Insurance Authority for insurance, etc.

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

In recent years, buyers have been less reluctant to accept indemnification clauses based on the breach of representations and warranties instead of "my watch-your watch" arrangements.

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?

Most listed companies in Brazil have a controlling shareholder and true corporations are still an exception. Acquisitions of controlling interest in companies with controlling shareholders are usually conducted as private transactions between the controlling shareholder and the buyer followed by a mandatory tender offer launched by the buyer to acquire all common shares held by minority shareholders. Depending on the listing segment of the portfolio company, the mandatory tender offer may be extended to all shares held by the minority shareholders.

In true corporations, the acquisition of controlling interest is usually executed through a voluntary tender offer launched by the buyer to acquire the controlling interests. To secure the success of the tender offer, the buyer may convince relevant shareholders to commit to sell a certain number of shares under the tender offer.

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

In most cases, private equity investors enter into a private deal with controlling shareholders of public companies and seek the same protections they would have in a private acquisition. The private deal executed between the controlling shareholder, as the seller, and the private equity investor, as the buyer, will usually include "my watch-your watch" provisions. On the other hand, if the acquisition involves a tender offer, there is no protection or assurance to the private equity investor.

Publicly traded companies are subject to a stricter regulation on the disclosure of information. Therefore, private equity investors can rely on different documents to assess the investment on a publicly traded company, such as reference form, audited financial statements and material facts issued by the company.

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?

When private equity investors are on the sell-side of the transaction, they generally look forward to obtaining a clean exit and/or for limited indemnification and/or obligations.

On the other hand, buy-side private equity investors prefer a more flexible indemnification approach, which might include "my watch-your watch" arrangements and more robust guarantees. In addition, private equity buyers may also request for the retention of key employees.

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 typical package of the representations and warranties offered by the seller and by the management of the portfolio company are usually focused on fundamental representations such as: (i) general capacity and authorisation to execute the share purchase agreement; (ii) inexistence of violations; (iii) corporate aspects (existence of shareholders' agreement, subsidiaries, and affiliates); (iv) financial statements; (v) existence of debts; (vi) intellectual property; (vii) labour; (viii) tax; (ix) litigation; (x) real estate; (xi) material agreements; (xii) related parties transactions; (xiii) insurance; (xiv) licences and regulatory aspects; (xv) environmental aspects; and (xvi) data protection.

It is also common for the share purchase agreement to provide for special indemnification clauses. The agreement will usually provide that the indemnification should also encompass unknown liabilities, and certain contingencies (e.g., fiscal and labour) may be subject to special indemnification mechanisms.

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?

Traditionally, private equity sellers do not accept restrictive covenants to ensure a clean exit. Non-competition and non-solicitation provisions will likely not be present in transactions involving private equity sellers, or such covenants are limited as much as possible and, if strictly necessary, are focused on the general partner of the fund. In some cases, the buyer will insist on restrictive covenants, which will usually cause the private equity seller to request for a significant increase in the valuation.

Moreover, if the buyer considerers that the management team of the private equity seller have acquired material information on the company's business, restrictive covenants might be imposed to such individuals. Private equity sellers will usually offer little resistance to the inclusion of such 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?

In recent years, insurance companies started offering representations and warranties insurance. However, this insurance only covers undisclosed liabilities and does not apply to known

liabilities mentioned in the representations and warranties or discovered on a due diligence report or the company's reference form.

If the private equity investor is on the sell-side, the agreement may be construed based on breaches of representations and warranties; in this case, an insurance policy might be contracted.

In these cases, the parties will usually establish special indemnification provisions for fundamental representations and warranties and focus more on undisclosed liabilities covered by 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?

Representations and warranties typically survive for five years post-closing, with tax representations and warranties surviving up to six years after closing, due to the longer statute of limitations of such liabilities.

The indemnification cap typically ranges from 5–20% of the purchase price and liability for breaches of fundamental representations and warranties, breach of covenants, fraud and special liabilities is often uncapped.

There has been a tendency of indemnity provisions to depart from the "my watch-your watch" construct to a more international and restrictive approach of breach of representations and/or covenants.

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)?

If on the sell-side, the private equity investors usually offer limited or no security to the buyer, because, as mentioned above, the goal is to provide a clean exit to the private equity investor. When a guarantee is provided, it usually involves escrow accounts, holdback of the purchase price or similar arrangements. Conversely, the private equity buyers usually do insist in the provision of more substantial guarantees, such as liens on remaining shares, real estate collateral or escrow instruments.

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.)?

It is uncommon for the buyers to provide comfort to the sellers relating to the availability of funds to perform its obligations under the share purchase agreement. Brazilian agreements are usually not financing-contingent and are executed on a firm basis. However, the transaction documents usually provide for certain representations and warranties by the buyer relating to its financial capabilities. If the investor fails to close the transaction, the seller might seek the specific performance of the agreement before a court or arbitration.

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

Reverse break fees are not prevalent in Brazil.

7 Transaction Terms: IPOs

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

In recent years, IPO exits became a viable alternative for private equity investments in Brazil. One of the main reasons for the recent increase on the Brazilian IPO markets was the strong decrease of the interest rates, which started in 2017 and encouraged investors to search for riskier investments to guarantee better returns. However, since 2022, high interest rates have reduced IPO exits in Brazil – we expect this scenario to change with a reduction in interest rates.

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

It is customary that the underwriters of the IPO impose a lock-up period for relevant or controlling shareholders. The lock-up period is usually negotiated for around six months, but there may also be established certain milestones that would release the lock-up.

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?

Yes, due to the uncertainty relating to the success of the IPO, private equity sellers usually pursue a dual-track strategy. This process usually begins before the IPO becomes public, due to the private equity seller becoming aware of the market's intentions relating to the deal. The most common result is unclear.

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 (including the syndicated loan market, private credit market and the high-yield bond market).

The most common source of debt finance is taken with large financial institutions through loans and bonds (debentures). It is uncommon to see high-yield bonds being used for private equity 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?

The only relevant restriction relating to debt financing is the fact that FIPs are not allowed to incur debt, unless specifically permitted by the CVM. This usually causes the investment to be structured by a holding company, as a subsidiary of the FIP.

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

After a period of low interest rates, we are seeing a constant

increase in the SELIC (Brazilian standard interest rate). Therefore, financing structured before local banks might become less common, and international financing might be a better alternative.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

Continuation fund vehicles and/or GP-led secondary transactions are not common in Brazil, although their use is increasing recently.

9.2 Are there any particular legal requirements or restrictions impacting their use?

Such funds are subject to the general requirements applicable to investment funds. In addition, a specific concern related to this structure is the management and reduction of conflict of interests.

10 Tax Matters

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

The main tax factor relates to the tax benefits available to structures involving FIPs. Brazilian Law provides for deferral of capital gains and income taxes to the moment when the proceeds are distributed to the FIP shareholders. In addition, if certain requirements are met, non-resident investors may benefit from special exemption on capital gains.

10.2 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 Brazilian tax system is known for great complexity and it is thus very difficult to set a definitive guide for the most tax-efficient arrangement. The incentive plans might be subject to ordinary income taxes and social security contributions if the incentive is recognised as a compensation. To avoid this undesirable and more costly structure the beneficiaries must effectively invest in the company and be subject to all the risks of the business.

10.3 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?

Where the idea is to roll over the investment into a new acquisition, the transaction should be treated as a contribution of assets into a new vehicle. This causes the capital gains taxes to be significantly reduced in comparison with structures that involve a disposal of assets.

10.4 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?

Currently, a tax reform is in discussion in the Brazilian Congress. The final terms of such reform are not yet defined, but there is a possibility of relevant changes to the FIP structure, removing most of its tax benefits.

11 Legal and Regulatory Matters

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

In recent years, there were many regulatory reforms and simplifications. With the intention of improving the business environment in Brazil, the government approved: (i) the Economic Freedom Act; (ii) corporations law reform related to the start-up industry; (iii) the Data Protection Law; (iv) enhancement of securities regulation; and (v) the general review and restructure of rules issued by regulatory bodies.

11.2 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 directed to private equity investors, but if a transaction is made in certain regulated sectors, prior approval by the regulatory bodies might be applicable.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

There are no specific legal or regulatory requirements for impact investments in Brazil.

11.4 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 perform extensive due diligence procedures. The investors will usually hire a full-service law firm, accounting and fiscal auditors and business consultants to conduct the due diligence. Compliance and regulatory matters are usually the mains aspects of the scope of the due diligence, which may include the performance of background checks and interviews with management members. The usual timeframe of the questioning is usually limited to five years prior to the due diligence; however, some aspects may require longer timeframes (up to 20 years for real estate matters). In relation to the materiality, the report resulting from the due diligence usually indicates the main red flags and relevant risks.

11.5 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.)?

Following many corruption investigations in Brazil, there were significant changes to the laws relating to anti-bribery and anti-corruption. Both the due diligence and the share purchase agreement considered these aspects. Also, after the implementation of the transaction, it is very common for the private equity investors to implement strict compliance policies in the invested companies.

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

There are some cases in which the Brazilian court may determine the existence of an economic group. In such cases, the affiliate companies may be held jointly liable for certain infringements. It is important to note, however, that the potentially applicable situations are very limited and usually involve labour, tax and consumer issues.

12 Other Useful Facts

12.1 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?

Private equity investors should consider that the Brazilian market is a developing market, which imposes certain risks but also great potential for profitable transactions. Investors must be aware that certain companies have family backgrounds and the business structures might not be as professional as expected.

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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?

After the private equity record levels reached in 2021, the North American private equity market settled back to its pre-pandemic levels in 2022. According to the year-end market overview report by the Canadian Venture Capital and Private Equity Association, $10 billion of private equity was invested in 890 deals in 2022. Middle-market deals continued to be a significant driver in terms of total value invested. In the face of the rising interest rates, national security concerns and economic uncertainty, private equity investors have focused more on small- and medium-sized businesses, with deals under $25 million comprising 85% of the deals that were closed in 2022. 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. Cleantech was the top sector in investment activity in the first months of 2023, with $883 million invested in over 11 deals.

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

Private equity firms continue to have record levels of dry powder on hand and increasing pressure to invest those funds; however, acquisition financing, while still readily available from third-party lenders, is becoming increasingly, and sometimes prohibitively, expensive as interest rates rise and some private equity firms are considering alternative structures or looking to alternative lenders to provide their financing.

Continuing economic uncertainty, rising inflation, supply chain instability, geopolitical tensions and a renewed focus on target financial performance are the most significant factors currently inhibiting deals. However, 2022 demonstrated stability with ongoing private equity activity across all sectors and industries, driven by continuing access to financing, the availability of ample dry powder on the buy-side and acceptable multiples on the sell-side.

From the private equity buyer's perspective, seller's valuation expectations have readjusted downward to a degree, but remain high compared to long-term averages. According to Crosbie & Co., companies with an enterprise value of $100–$250 million traded at an average of 9.1×, a premium of 40% to small companies with an enterprise value of $10–$25 million, which traded at an average of 6.5×. 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 and geopolitical events.

The high activity level in the mid-market coupled with the lower Canadian dollar continues to make Canadian targets attractive to foreign private equity buyers, especially if the targets have, or have the potential to, establish a presence in the United States and are therefore able to generate revenue in US dollars.

1.3 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 continuing to be active and independent participants in the private mergers and acquisitions space. When these investors compete against private equity firms in an auction setting, they tend to offer private-equity-like transaction terms, including no indemnity deals backstopped by the use of representations and warranties 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 are typically 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 that will service the debt. 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. Add-on acquisitions continue to account for over 75% of private equity buyouts in Canada, which is an accurate representation of the trend over the last five years. With that said, while buyouts remain the preferred form of investment, minority investments, once only common in smaller growth equity deals, are a continuing and increasingly popular trend due in part to the rising cost of borrowing.

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 both 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 (obtaining full-cost basis in the acquired assets) 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. Furthermore, certain permits and licences may not be transferable or assignable in an asset sale. In contrast, a share sale is relatively simple from a conveyancing perspective and less likely to trigger third-party consent requirements or a need to apply for new licences or permits by the purchaser. From the seller's perspective, tax considerations generally favour share transactions, as individual sellers may be able to utilise their $971,190 (as of 2023) lifetime personal capital gains exemptions to shelter a portion of the proceeds and there is no recapture of depreciation that occurs on a sale of assets. Changes to Canadian tax rules in 2021 have seen "hybrid" transaction structures, which were previously popular for providing tax advantages to both buyer and seller and involved selling shares and assets as part of the same transaction, to be largely ineffective.

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 roll over equity into a Canadian 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 shareholder agreement become a 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 time and/or performance-based 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 scheduled 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' board of directors are publicly available information. In response to foreign pressures to bring disclosure of ownership of Canadian corporations in line with other major countries, the federal government committed to improve beneficial ownership transparency by creating a national public and

searchable beneficial ownership registry for federally incorporated businesses. The Canada Business Corporations Act currently requires federally incorporated businesses to maintain a record of beneficial owners in their corporate records. On March 22, 2023, the Government of Canada tabled legislation that would require private federal business corporations to report beneficial ownership information to Corporations Canada annually and within 15 days of any change in beneficial ownership. In Quebec, legislative changes took effect on March 31, 2023 that made beneficial ownership information with respect to owners of Quebec corporations publicly available. Similarly, Ontario, British Columbia, Manitoba, Saskatchewan, Nova Scotia, and Prince Edward Island have also introduced comparable amendments to their corporate legislation, requiring companies to privately report or maintain records of their beneficial ownership structures. As a consequence of these various amendments, the public availability of this information is not consistent across Canadian jurisdictions; however, there is certainly a growing trend towards greater 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. In applicable Canadian jurisdictions, USAs are effectively part of the articles of a corporation. 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 (so-called USAs as described above). At the director level, only certain powers of directors can be fettered by a USA 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. Residency requirements only remain under the federal statute, and the corporate statutes of Manitoba, Newfoundland and Labrador, and Saskatchewan. No other provinces provide for director Canadian residency requirements, thus making such 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; bankruptcy and insolvency; and environmental. In Quebec, amendments to the Charter of the French Language also provide for potential liability for directors in the case of non-compliance with French language legislation by a corporation.

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. Notably, Alberta's corporate statute contemplates a corporation's ability to include a "corporate opportunity waiver" in its articles or in a unanimous shareholder agreement. Alberta is the first to introduce this waiver, which is beneficial to directors, officers and shareholders of a corporation wishing to take advantage of certain business opportunities. This is particularly attractive to private equity investors who may wish to take advantage of business opportunities afforded to them by being engaged with several different boards and management teams operating in the same industry.

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. Amendments to the Competition Act have resulted 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 are thus included in the threshold analysis. This has been 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. Consistent with other jurisdictions globally, Canada has seen a broadened interpretation of what constitutes "national security" and consequently more transactions are potentially subject to this review. Under the Investment Canada Act, non-Canadian investors are also permitted to submit a voluntary notification of such investments, and such voluntary filings are also subject to a national security review.

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. Earn-out provisions have also become increasingly popular as a way to bridge the valuation gap and to work around business uncertainties caused by the pandemic and have continued to persist post-pandemic. The Canadian market has also increasingly seen public-company style "no-indemnity" deals as in the U.S. market. Also, the use of representations and warranties insurance is increasingly being seen as standard in the Canadian private equity market and impacts what terms are "market" in deals using that product.

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. Typically, an interested investor will have entered into a binding commitment letter with a financial institution or other provider of funds before making a takeover bid. On the other hand, statutory plans of arrangement 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, provisions relating to the fiduciary duties of the public target's board and 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 following the COVID-19 pandemic as a way for transaction parties to account for uncertain future performance without discounting a company's purchase price. While still relatively rare, the use of "locked box" structures is growing 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 (although most agreements remain silent with respect to sandbagging provisions). Private sellers are also increasingly insisting on public-company style "no-indemnity" exits. This is in part due to the growing familiarity with and acceptance of representations and warranties insurance in the Canadian market.

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?

Representations and warranties insurance use is not universal, but, as noted above, has become commonplace and is now widely used 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 is now available for both fundamental and non-fundamental representations and warranties with very few exclusions. Over recent years, the number of typical carve-outs and exclusions from such policies has decreased quite significantly. However, typically they remain for pension funding, certain environmental matters (including asbestos), sanction matters and other high-risk deal-specific terms. In addition, certain exclusions can arise out of deal-specific matters that present themselves during the due diligence review process. Apart from a short "blip" at the end of 2021, where deal flow exceeded the ability of the insurers to keep up with demand and premiums increased, generally policy premiums for representations and warranties insurance have remained quite low and generally range between 2.5–4% of the policy limit, with retention amounts typically ranging between 0.5–1% 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 representations and warranties 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. In instances where a financing condition is in place, some transactions contemplate a reverse break fee that sellers are entitled to if the transaction does not close as a result of the financing condition not being met.

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, initial public offering ("IPO") exits are not common in Canada and are the exception rather than the typical exit scenario. According to the Canadian Venture Capital and Private Equity Association, while the Canadian exit market saw 21 exits with a total value of $41 million in 2022, no IPO exits were reported. The most common exit is now the sale to another private equity fund. 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 increased use of these processes in the United States, we expect them to become 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 (including the syndicated loan market, private credit market and the high-yield bond market).

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. The private credit market can serve to fill the gap in providing funding to Canadian small- and middle-sized businesses who may prefer the flexibility of an alternative lender, such as flexibility in repayment schedules and structure. Since 2021, the private credit market has extended over $17 billion to Canadian deals.

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 consisted of 50% in 2022 and rose to 54% in the first quarter of 2023 as interest rates continued to heighten.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

Historically, the use of continuation funds in the Canadian private equity market has been limited. When used, continuation funds were typically used as investment vehicles by sponsors that needed additional time to manage a portfolio company before their exit. However, continuation funds have since become more popular, offering investors the option to exit the investment in the portfolio company or remain invested by rolling into the continuation fund. While the formation of continuation funds has decreased since its record highs in 2021, they remain attractive for private equity firms considering alternative exit strategies, especially where they feel certain of their assets could benefit from a little more "seasoning".

9.2 Are there any particular legal requirements or restrictions impacting their use?

The Institutional Limited Partners Association ("ILPA") provided guidance on May 15, 2023 relating to continuation funds. Pursuant to the guidance document, the ILPA recommends certain parameters to align interests between the general partner and limited partners. The recommendations were developed through two operative guiding principles: (i) continuation funds should maximise value for existing limited partners; and (ii) limited partners that roll into the continuation fund should be no

worse off than had the transaction not taken place. While the ILPA sets out recommendations that are not legally required, the guidance looks to protect the interests of limited partners in private funds, and similar to the United States, the Canadian market and Canadian private equity investors are mindful of that guidance.

10 Tax Matters

10.1 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 were often 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 has significantly affected the usage of such intermediaries.

10.2 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 equity-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 equity-based compensation arrangements for management include stock appreciation rights and deferred stock units.

10.3 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).

10.4 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 amount of stock option deduction that is available in certain circumstances is restricted. For stock options granted after June 30, 2021, there is a $200,000 annual limit on the eligibility of employees of certain businesses to claim a 50% tax deduction for those stock option grants. This could affect the compensation packages required to retain and incentivise management.

11 Legal and Regulatory Matters

11.1 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), most of which came into force on June 23, 2022 as part of the Budget Implementation Act, 2022, required that: (i) companies ordered to produce information must also provide information in the possession of their affiliates; and (ii) persons outside of Canada provide information. This increases the number of entities that may be subject to the orders made to companies to produce information in the possession of their affiliates. Combined with the 2021 amendments to the Competition Act, which included non-corporate entities as affiliates, private equity funds are now potentially subject to much broader information requests, which may include both their domestic and foreign portfolio companies and any other similarly structured sister funds controlled by the same entity.

Changes to the national security review regime under the Investment Canada Act came into effect on August 2, 2022 to permit non-Canadian investors to submit a voluntary notification of such investments that are not subject to a mandatory filing. The Canadian government may initiate a national security review within 45 days of receiving a voluntary filing.

11.2 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. Further, as noted above, amendments to the national security review regime under the Investment

Canada Act create a process by which non-Canadian investors are permitted to submit a voluntary notification for a minority acquisition of a Canadian business and the acquisition or establishment of a business with only limited Canadian aspects (i.e., some Canadian employees or Canadian assets). While these acquisitions are not subject to a mandatory filing, the Canadian government may initiate a national security review within 45 days of receiving a voluntary notice of such investment from the non-Canadian investors. As noted above, consistent with other jurisdictions globally, Canada has seen a broadened interpretation of what constitutes "national security" and consequently more transactions are potentially subject to this review.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

Impact investments are not subject to additional legal or regulatory requirements.

11.4 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 fairly comprehensive legal due diligence, reviewing all material legal documents, including the target entity's corporate records, materials contracts and employment records for any "red flags". 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 virtually by external counsel (increasingly with the assistance of AI) 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; such length has increased on average following the COVID-19 pandemic (when it was shortest).

11.5 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.

11.6 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, including where a USA or unanimous shareholders declaration is used to remove the powers of the directors and instil such powers in a shareholder.

12 Other Useful Facts

12.1 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, railway, airline, 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. Due to the Russian invasion of Ukraine, Canada has also introduced an increasing number of constraints on trade and financial dealings with Russia. These restrictions have introduced new considerations for Canadian private equity investors and can constrain the opportunity of certain private equity funds to invest if Russian investors are present in the funds. Further, many Canadian businesses do business with Cuba and Canada maintains blocking legislation that prevents the extraterritorial application of U.S. sanctions on Cuba (creating a conflict with U.S. law). Lastly, amendments to the Competition Act (Canada) came into effect on June 23, 2023, to criminalise wage-fixing and no-poaching agreements between unaffiliated employers. These amendments prohibit agreements between employers: (i) to fix, maintain, decrease or control salaries, wages or terms and conditions of employment; or (ii) to solicit or hire each other's employees. Non-solicitation provisions are common in the context of M&A transactions. While the Competition Bureau released guidelines providing that the Bureau will "generally" not assess clauses that are ancillary to merger transactions and joint ventures, consideration should be given to ensuring certain types of M&A agreements (i.e., NDAs and exclusivity agreements) do not pose legal risks in light of these amendments. Furthermore, emphasis should be given during the due diligence process to ensure that these types of provisions are not commonplace in a target's commercial agreements as these should now be considered "red-flag" issues, whereas they previously may not have met such a threshold. Finally, in the province of Quebec specifically, recent changes enacted to French language legislation and privacy legislation raise further considerations in terms of investment in entities with operations in Quebec. Where investments involve such entities, consideration may be given to the increasingly onerous obligations for such entities to comply with French language requirements.

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McMillan is a leading business law firm serving public, private and not-for-profit clients across key industries in Canada, the United States and internationally. With recognised expertise and acknowledged leadership in major business sectors, we provide solutions-oriented legal advice through our offices in Vancouver, Calgary, Toronto, Ottawa, Montréal and Hong Kong. Our firm values – respect, teamwork, commitment, client service and professional excellence – are at the heart of McMillan's commitment to serve our clients, our local communities and the legal profession.

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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. 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 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 in turn be 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 an exempted 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 or 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 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 him or 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 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-exempt 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 initial public offering ("**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 (including the syndicated loan market, private credit market and the high-yield bond market).

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 (including through the syndicated loan market and private credit market). Common private equity financing structures include subscription line facilities secured on investors' capital commitments, and leveraged finance or "NAV" facilities secured by the relevant target group's assets. Cayman Islands vehicles also feature frequently in lender-side structures in the private credit market.

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 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

The formation and launch of continuation fund vehicles and other types of private equity secondary transactions (including GP-led secondaries) is prevalent in the Cayman Islands given the jurisdiction's legislative and regulatory framework, tax-neutral status and flexible structuring options. The volume of secondary transactions in the Cayman Islands, notably GP-led secondaries, has increased in recent years in line with the general industry trends and the increasing number of investment fund vehicles whose terms are expiring and that are seeking liquidity options.

9.2 Are there any particular legal requirements or restrictions impacting their use?

There are no specific Cayman Islands statutory restrictions impacting the formation and launch of continuation fund vehicles or the structuring of other secondary transactions. Such transactions will be subject to the same Cayman Islands laws, general partner fiduciary duties, disclosure obligations and general regulations that apply to private equity funds and related structures in the jurisdiction, as described in more detail in this chapter.

10 Tax Matters

10.1 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.

10.2 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.

10.3 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.

10.4 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.

11 Legal and Regulatory Matters

11.1 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.

11.2 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.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

Cayman Islands domiciled private equity impact funds are not subject to any additional laws or regulations in the Cayman Islands. In most cases, such private equity funds will be making impact investments in foreign jurisdictions outside of the Cayman Islands. As a general observation, the formation and launch of impact funds and ESG funds in the Cayman Islands is increasing in-line with the global investment funds market given the jurisdiction's leading legislative and regulatory framework, tax-neutral status, flexible structuring options and experienced service providers.

11.4 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.

11.5 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.

11.6 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.

12 Other Useful Facts

12.1 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 2022, the number of active exempted limited partnerships stood at 37,640, compared with 35,075 in 2021, 31,733 in 2020 and 28,469 in 2019. 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?

The most common types of private equity transactions in the People's Republic of China (PRC) are mergers and acquisitions (M&A), growth investments, and a nascent restructuring market. The leveraged debt financing market is becoming more common, especially in M&A.

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

Two significant factors have brought increased certainty to the market. The first is China's emergence from COVID-19 restrictions, which may result in a release of pent-up demand, especially from Asia-focused funds who raised significant amounts for deployment in the PRC market. The second is China's release of specific rules, which came into effect on 31 March 2023, regulating for the first time the overseas (i.e. anywhere but Mainland China) IPOs of Chinese businesses with offshore structures. Geopolitical uncertainty continues to be an overhang on the market, particularly U.S. export controls impacting portfolio companies and potential U.S. investment restrictions on certain sectors of the Chinese economy.

1.3 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 PRC market has international private equity investors and a burgeoning group of local or Asia-focused private equity investors who have raised USD, RMB, or USD and RMB funds. There are also government-backed or government-sponsored funds, primarily RMB funds. The practice of local or Asia-focused private equity investors differs slightly from international private equity investors in terms of the level of flexibility they have with terms and legal risk.

2 Structuring Matters

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

There are a diverse range of transaction structures for PRC private equity transactions. The most straightforward structures for international private equity investors are non-PRC parent structures, which allow investors to use structures they are familiar with in other jurisdictions, such as a U.K.-style merger or Silicon Valley-style growth documents. However, asset acquisitions and PRC structures are becoming more and more prevalent, especially as new offshore IPO rules take effect.

2.2 What are the main drivers for these acquisition structures?

The main driver for an acquisition structure, whether the transaction is an acquisition or a growth investment, is the current group structure of the target. If the group structure has a parent entity outside of the PRC (typically in the Cayman Islands), then transaction structures available in other jurisdictions are possible. If, however, the group structure has a parent entity in the PRC, then transaction structures available in other jurisdictions such as mergers are no longer possible.

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

If the purchaser is a USD fund, whether controlled by general partners who are PRC nationals or non-PRC nationals, the economics of a fund are similar to other jurisdictions in terms of management and carried interest. If the purchaser is a non-USD fund, the terms are similar but not exactly the same. For example, certain limited partners that may have government affiliations may demand more rights over the procurement of investment opportunities.

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

The structuring considerations are generally the same for a growth investment as they are for a transaction resulting in a change of control. A unique consideration in growth investments is whether the rights granted to the investor would

result in "control", which may trigger an antitrust filing under enhanced new rules that took effect on 1 August 2022.

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 for equity allocated to management, and the terms of such equity, varies significantly in the PRC depending on the sector. Targets with high cash burn rates consumed for the purposes of user acquisitions may have more management equity, while targets with specific product development objectives such as life sciences may have less management equity, but this is not a general rule. Vesting conditions can vary from monthly to annual vesting, but accelerated vesting is typically only granted to founders and senior management.

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

The reasons are determined by contract and not by law as it relates to management equity. The distinctions are generally tied to length of service and compliance with employment-related undertakings, such as confidentiality and non-competition (which is permitted in the PRC as long as the employee receives compensation during the non-competition period).

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 an offshore structure where the target's parent entity is located in the Cayman Islands, corporate decisions are made by the board of directors except for special resolution items such as amending the articles of association that have to be approved by two-thirds of the shareholders. The register of members, register of directors, register of chargers, and memorandum and articles of association are not publicly accessible.

With respect to PRC subsidiaries in offshore structures and an onshore structure where the target's parent entity is located in the PRC, corporate decisions are made by the board of directors, documents are executed by the legal representative, the general manager or managers direct the day-to-day management of the entity, and these appointees are supervised by a supervisor or a board of supervisors independent from the board, legal representative, and the general manager or managers. In an onshore structure where the target's parent entity is located in the PRC, shareholder approval is required to amend the articles of association. The particulars of the shareholders, board of directors, and other legally appointed persons are publicly accessible. The articles of association and incorporation documents are not publicly accessible but PRC lawyers and the company itself have the authority to request them from the local registration office.

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 growth transactions, the existence of individual veto rights is generally more prevalent in the PRC compared with other jurisdictions where there may be class voting by preferred shareholders or certain classes of preferred shareholders. The individual veto rights typically extend to economic rights, such as IPO, trade sale, and amending the articles of association. Operational veto rights also exist depending on the level of control an investor seeks to exert, and their extent will also impact whether or not a merger review filing is required or not.

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?

Under the PRC's merger review standards, an individual veto right, whether at the shareholder or director level, over the budget and business plan, the appointment or dismissal of officers, as well as matters relating to an employee stock ownership plan, management remuneration, investment projects and disposal of intellectual property rights without high shareholding or monetary thresholds, would be deemed "control", thereby necessitating a merger review filing if the merger review thresholds are met, even though the underlying transaction is a growth transaction.

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?

Directors appointed by the private equity investor have a fiduciary duty to act in the best interests of the company, whether the entity in the group structure is incorporated in the PRC or Cayman Islands. Generally speaking, acting in its capacity as a shareholder, absent specific contexts in a PRC liquidation, such shareholder does not owe any fiduciary duties to other shareholders in the PRC or Cayman Islands.

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)?

In an offshore structure where the target's parent entity is located in the Cayman Islands, the governing law is typically Hong Kong law and Hong Kong arbitration at the Hong Kong International Arbitration Centre (HKIAC). In 2019, Mainland China agreed to allow litigants in an HKIAC arbitration to pursue interim relief in the PRC, which is an enforcement advantage that has led to transaction parties electing arbitration at the HKIAC. In an onshore structure where the target's parent entity is located in the PRC, generally speaking the governing law cannot be moved outside of Mainland China as there is no sufficient "foreign element" in the transaction, even if the private equity investor is incorporated outside of the PRC.

Non-compete and non-solicitation provisions are typically enforceable in the PRC so long as the employee receives consideration during the period of the non-compete. The amount of monthly minimal consideration varies by province but, in general, it is at least 30% of the average monthly salary in the 12 months prior to the departure.

In an onshore structure where the target's parent entity is located in the PRC, a redemption provision is generally unenforceable as to the company. Transaction parties do frequently attribute joint and several liability for the redemption onto the founders, though this provision is infrequently invoked in practice.

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 nationality restrictions for board appointees of PRC entities (either operating subsidiaries in an offshore structure or onshore structure). Generally speaking, the legal representative, a legally appointed person who has the power to execute documents on behalf of PRC entities, is the first line of defence if a governmental authority requests documents or information from a PRC entity. Director liability is generally limited to the obligation to act in the best interests of the company. Shareholders are generally not liable unless they are held by a court to be one and the same with the entity itself, roughly analogous to the standards for "piercing the corporate veil" in other jurisdictions.

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?

Apart from exercising their general fiduciary obligations to the company, the articles of association in a PRC operating entity or a Cayman Islands entity in an offshore structure may contain specific provisions pertaining to the handling of potential director conflicts of interest and corporate opportunities.

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?

From the perspective of international private equity investors, the first fundamental consideration in any M&A or growth transaction is an examination of whether the underlying business is subject to foreign investment restrictions in the PRC. This consideration has increased in significance with the enactment of the offshore IPO rules, whose regulators will carefully scrutinise foreign investment restrictions and non-PRC shareholding in any subsequent proposed IPO outside of Mainland China. The major industries restricted to foreign investment are Internet content services, which require an Internet content provider (ICP) licence, with a 50% foreign investment limit. The major industries prohibited to foreign investment are online videos, cloud computing, news and streaming services, and K-12 education. The variable interest entity (VIE) structure has been a structure in existence for over 20 years, which allowed foreign investors to invest in restricted or prohibited sectors through an arrangement where the key licences are held by an entity under contractual control as opposed to shareholding control. Notwithstanding the fact that major PRC Internet companies have used the structure to attract private equity investment and then list in Hong Kong or the U.S., the enactment of the offshore IPO rules and their subsequent implementation raises significant uncertainty to the continued viability of past practices in restricted or prohibited industries. There is an additional approval regime for target companies who hold user data on at least 1 million individuals that applies to U.S. listings but not Hong Kong listings.

The PRC recently updated its Anti-Monopoly Law, which raises filing thresholds but also the consequences of non-compliance, from RMB500,000 to up to 10% of global turnover. Under the new Anti-Monopoly Law, an expedited review where a decision is made in as little as one to two months is possible.

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

To account for the changes set forth in question 4.1, transaction terms now have special redemption provisions, mandatory buy-backs, and assistance with offshore IPO applications.

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 most common public-to-private transactions involving PRC companies are take-privates of U.S. listed PRC companies, and the acquisition of PRC companies listed on the Stock Exchange of Hong Kong. The market for the takeover of companies listed in Mainland China is still at a nascent stage. For take-privates of U.S. listed companies, the major hurdle is not necessarily shareholder approval as the companies almost always have unweighted voting arrangements, but rather the composition of the special committee and the inevitable class action lawsuits filed for the purposes of increasing price. The most time-consuming item is the adjudication of these class action lawsuits. For the acquisition of Hong Kong listed companies, Hong Kong has a takeovers regime requiring over 30% shareholders to tender shares to all other shareholders and attain 75% or more of the votes of independent shareholders in order for the acquisition to proceed. The existence of these requirements should be considered when negotiating the timing of the acquisition and discussions with selling shareholders. Antitrust merger review filings would also apply for the above take-privates of U.S. listed companies and acquisitions of Hong Kong listed companies.

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

For take-privates of PRC companies listed in the U.S., the most common deal protection for an acquirer is to set a deadline for completion, after which the acquirer is entitled to terminate the transaction. For the acquisition of Hong Kong listed companies, the most common deal protection is the assurance that the requisite takeover thresholds (namely attaining 75% or more of the votes of independent shareholders) can be met.

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 preferred consideration structure for both sell-side and buy-side tends to be cash without other forms of consideration. An exchange of shares is also present for portfolio companies that merge. Consideration paid to a target incorporated in the PRC may be paid in USD.

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 typical package of warranties will relate to all aspect of the target's business and will be given by the seller and the management on a joint and several basis. PRC-specific warranties relate to foreign exchange, cybersecurity, and compliance, allowing the target to list in the future. As very few PRC targets are perfectly compliant, holdbacks and indemnification escrows exist but are being replaced by warranty and indemnity (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?

For growth transactions, covenants tend to be both broad (general compliance with law) and specific (items of non-compliance identified in legal due diligence). For M&A, the covenants tend to be limited, especially for the selling shareholder, unless the founding team remains with the target, although transition services are also present.

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 is becoming more common in the PRC market, especially for sellers who are private equity investors. In addition to international insurers, there are also local PRC insurers active in the W&I insurance market. Exclusions typically cover market factors such as changes to the law and the regulatory environment, and uncertainty in new laws and their implementation, which may impact the target's business, although these can also be negotiated. The cost of W&I insurance varies significantly depending on sector and corporate structure.

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 limitations are an indemnity basket and liability exclusions for matters disclosed in a data room. In the PRC market, however, there are special indemnity items to account for potential regulatory action for past non-compliance, even if these actions occur after completion.

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)?

Holdbacks and indemnification escrows are gradually being replaced with W&I insurance, although they are still present in the market. There are still milestone-related management earn-outs tied to financial metrics that occur after 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.)?

The most common protection for sellers is an equity commitment letter from the buyer or another affiliate parent entity of the buyer with significant assets. The right of specific performance is the most common remedy for a seller in the event of a breach by the buyer. Sellers also may require assurances of debt financing being secured prior to even signing.

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 and break fees generally are not very common in the PRC market. However, they can be used to account for overseas direct investment (ODI) approval risk (see question 12.1) and completion risk associated with not obtaining antitrust 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?

The most significant features are the offshore IPO rules, which came into effect on 31 March 2023, the cybersecurity review rules, which came into effect on 15 February 2022, and their implementation. The importance of these rules for international private equity investors pursuing an IPO exit in Hong Kong or the U.S. cannot be overstated, as they regulate an area that was once effectively unregulated for companies with an offshore structure. The cybersecurity review rules require prior approval from the Cyberspace Administration of China (CAC) for targets who hold user data on at least 1 million individuals and are applying to list anywhere other than Mainland China or Hong Kong (including the U.S.). These cybersecurity reviews are time-consuming, cumbersome, and do not always result in a successful outcome. For both listings in Hong Kong and the U.S., compliance with foreign investment restrictions and prohibitions are now paramount, with prior workarounds such as the variable interest entity structure facing significant uncertainty. In addition, the target will need to produce a compliance certificate from its primary regulator, meaning prior legal due diligence practices such as relying on prospectus disclosures of non-compliance will no longer be adequate.

On 24 March 2023, the Stock Exchange of Hong Kong released special rules and standards for designated specialist technology companies, which expands listing options in Hong

Kong. On 7 April 2023, the China Securities Regulatory Commission released its first batch of approved offshore listings, with all three being Hong Kong listings.

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

In a Hong Kong IPO, a controlling shareholder holding 30% or more of the listed company's voting rights is subject to a six-month statutory lock-up period. For non-controlling shareholders and U.S. listings, underwriters will typically require a six-month lock-up 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?

Dual-track potential exits were less common in the PRC market, but are expected to be more common for target companies who will encounter difficulties in achieving an IPO due to the recently enacted offshore IPO rules. When exploring an exit, sellers usually select an exit option over the other.

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 (including the syndicated loan market, private credit market and the high-yield bond market).

The most common form of debt financing for private equity transactions is borrowing from traditional banks, either on a singular or syndicated basis. The use of debt instruments for PRC transactions tends to follow trends first used by international private equity investors in other jurisdictions. The market for high-yield bonds is still at a nascent stage.

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 provision of security by PRC persons or the use of PRC assets as security to a foreign debtor are subject to registration requirements from the State Administration of Foreign Exchange. Furthermore, if the term of a foreign debt exceeds one year, approval from the National Development and Reform Commission is also required. In practice, PRC individuals cannot in practice complete the required registration, complicating enforcement. The registrations made by PRC entities to provide security and the security of PRC assets can be completed in practice.

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

The use of debt financing for private equity transactions involving PRC target companies has tended to follow developments in other jurisdictions. It is still fairly uncommon in growth transactions but is gaining tracking in M&A.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

Due to rapid growth in Asia generally, and China in particular, in the past decade, international private equity investors generally did not need to consider continuation funds as they were able to exit within the original fund's life. For secondary transactions, international investors who invested in a target operating in a restricted or especially prohibited industry are facing the prospect of holding an illiquid asset with the advent and implementation of the offshore IPO rules. Therefore, secondary transactions, especially where stakes are sold to PRC investors, may become a viable alternative.

9.2 Are there any particular legal requirements or restrictions impacting their use?

International private equity investors who have USD funds are usually not subject to the PRC's jurisdiction at the fund level. Those who raise RMB funds will have to obtain a fresh set of approvals to establish a continuation fund. Secondary transactions within the fund may also be necessitated by "reverse CFIUS" restrictions by the U.S. on investments in specified sectors of the China's economy.

10 Tax Matters

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

Whether a target company has an offshore or onshore structure, private equity investors typically use an offshore entity as the holding vehicle. The most common form of tax structuring is to use a Singapore holding vehicle in order to enjoy the benefits of the double taxation treaty between the PRC and Singapore. Offshore structures are now subject to the same regulation on offshore IPOs as onshore structures, so their use may become less common over time.

10.2 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)?

Generally speaking, asset acquisitions would involve a higher tax burden for the sellers, but they are still used by strategic buyers. Typically incentive shares, however structured, would result in the same tax liability for PRC beneficiaries.

10.3 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 typically involve the amount of cash consideration management will receive at completion and whether future payments are tied to earn-outs. Generally speaking, the roll-over of equity from the seller to the buyer or to a new merger parent company is a taxable event where capital gains tax is due on the premium. Generally speaking,

the roll-over of options from the seller to the buyer or to a new merger parent company is a tax-neutral event as long as the vesting terms do not change or accelerate. There have been transactions where the target companies were required to provide limited tax indemnities or reimbursement programmes for shareholders (including management shareholders) who incurred capital gains tax as a result of a merger.

10.4 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 PRC already has an established tax regime on indirect share sales of PRC companies with offshore structures. There have been no significant developments since that change was made in 2015.

11 Legal and Regulatory Matters

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

The PRC's offshore IPO rules, which came into effect on 31 March 2023, the cybersecurity review rules, which came into effect on 15 February 2022, and their implementation, are perhaps the most consequential legal changes in the market in the last 20 years. Their impacts on IPOs are set forth in question 7.1. The market is also bracing for additional "reverse CFIUS" restrictions from the U.S. that may prevent U.S. investors, including limited partners, from investing in specified sectors of the China's economy.

11.2 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 treated any differently as a class compared with other non-PRC investors. Investments in restricted or prohibited sectors by non-PRC investors, mainly involving the distribution of content online, are more sensitive than other industries, which the PRC has effectively opened on a broad and unfettered basis. The PRC also has a foreign investment review regime similar to the U.S. CFIUS regime that came into effect on 1 January 2020. While initial implementation was slow, it is now a required consideration in any transaction where a non-PRC investor will attain "control" in a target operating in any specified sector.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

Impact investments that attract headlines may receive additional scrutiny, especially if they involve any of the large private companies that have recently been investigated as part of the PRC's heightened regulation of the previously unregulated technology sector. However, international investors should not assume that there will be less scrutiny or lower risk if the investment is not headline-grabbing.

11.4 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 advent of the offshore IPO rules and cybersecurity reviews as specified in question 7.1 will mean that diligence will be heightened as it will impact a future IPO exit. Any identified deficiencies will therefore have to be remedied by completion or prior to an IPO exit. Some private equity investors prefer a stepped approach to legal due diligence, where gateway items such as foreign investment restrictions, offshore listings potential, and structuring issues are handled first prior to other diligence items.

11.5 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 PRC's anti-bribery and anti-corruption regime has been enforced with more regularity recently. The basic approach to anti-bribery and anti-corruption legal due diligence and contractual protections, however, has remained relatively unchanged.

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

Shareholder liability under PRC law is rare and will only arise if the shareholder and the underlying portfolio company are held by a PRC court to be one and the same. This situation can arise where all or substantially all of the directors and other legally appointed persons are associated with the private equity investor and not the portfolio company itself, which is a rare arrangement for private equity investors in the PRC. There is no mechanism under PRC law under which one portfolio company can be held liable for the liabilities of another portfolio company.

12 Other Useful Facts

12.1 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 unique aspects of PRC practice that may not be present in other jurisdictions is foreign exchange and the fact that the PRC does not yet have an open capital account. This impacts both financial and legal due diligence and involves legal requirements that may be unique to the PRC. For example, in order for a PRC person to hold equity in an entity incorporated outside of Mainland China acting as the parent entity for the business, a special registration with the State Administration of Foreign Exchange is required. In order for investors in the PRC to invest in or acquire portfolio companies using funds from the PRC (including converting RMB in the PRC into USD outside of the PRC), an overseas direct investment (ODI) approval is required to convert RMB into USD. This approval has become more administrative over the years but is still subject to general foreign exchange trends such as currency outflows, as well as foreign investment restrictions.

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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 (PE) transactions refer to investments achieved by PE investors at different stages of a company's life, from venture capital (VC) investments (pre-seed or seed stage), growth or expansion capital investments (early or late stage), to buyout investments (leveraged buyout (LBO), leveraged management buyout, buy-in management buyout, family buyout, etc.) and exit transactions. The French PE landscape, which has always been welcoming PE transactions, comprises PE funds focusing on LBO transactions involving mature companies and a multiplicity of VC funds interested in venture and growth capital transactions.

After the 2021 post-COVID peak, the LBO and VC transaction flow stayed strong until 2022, began to slow down and then fell as from the last Q22, with lower deal valuations, lower quantities of funds raised, and lengthier negotiation timeframes, even if it seems that PE activity in France has a bit bounced back in Q1 2023.

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

French economy has been able to show signs of resilience and maintain its appeal for PE transactions notwithstanding the current uncertain global economic environment (i.e., inflation, invasion of Ukraine, energy crisis, supply chain issues, increased market interest rates). Indeed, the political will to swiftly relocate strategic industries, the urgency of global warming, the rise of Web3 and deep tech companies, and the advancement of environmental, social and governance (ESG) goals, coupled with the French government's recent and promising initiatives (French Tech, France 2030, etc.) have been encouraging factors to PE transactions, despite the current worldwide inhibiting factors and some new regulations (such as foreign investment or antitrust) that may have curbed or prevented the completion of certain transactions.

1.3 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.

Industrial companies use the completion of build-up/PE or VC-like transactions to adapt their activity to the market's new expectations (e.g., relocation of production activities, reduction of carbon footprints, or diversification of activities) by acquiring other companies or taking stakes in start-up companies. These transactions may combine M&A transaction philosophy and deal terms with PE or VC transactions financing and structure.

2 Structuring Matters

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

Usually, acquisition vehicles (used for completing a transaction) are incorporated under the form of regular companies such as "*société anonyme*" (SA) or "*société par actions simplifiée*" (SAS) or specific companies such as VC companies (*société de capital-risque* – SCR), enjoying legal personality but still delegating the management of their funds to a management company.

Under French law, investments funds can be incorporated under the form of specific legal structures governed by the French Monetary and Financial code and the French Financial Market Authority (Autorité des Marchés Financiers – AMF), known as "alternative investment funds" (FIA). FIAs raise capital from investors to invest it following a predefined investment policy. The most commonly known structures are PE mutual funds, including VC mutual funds (*fonds commun de placement à risque* – FCPR), innovation capital mutual funds (*fonds commun de placement dans l'innovation* – FCPI) and other professional funds, such as professional PE fund (FPCI). These funds are deprived of legal personality and managed by a management company (*société de gestion*).

2.2 What are the main drivers for these acquisition structures?

The acquisition vehicles' structure may differ based on legal and tax considerations and depending on whether the transaction is organised as an assets deal, a share deal, a merger, etc., but are mainly incorporated under the corporate form of SAS (see questions 2.3 and 3.1 below).

The structure of the investment funds is mainly driven by: (i) the nature (either professional or non-professional) of their ultimate funders (i.e., opposing structures opened to non-professional funders, *inter alia*, FCPR, FCPI *and fonds d'investissement de proximité*, to those opened to professional funders, *inter alia*, FPCI *and société de libre partenariat*); (ii) the tax regime attached to the subscription of the securities issued by those structures and the capital gains achieved by said structures; and (iii) the sector, area of industry

and type of assets into which the investments are to be made, as specific types of funds must comply with certain investments ratios.

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

Regarding LBO transactions, PE investors usually acquire the entire issued share capital of the target company to fund its growth through, for instance, completion of build-up transactions. The acquisition is completed through a dedicated holding company (HoldCo), usually incorporated under the form of a SAS (see question 3.1 below), funded by the PE investor and other financial partners (such as banks) to acquire the target company.

PE investors often require the key managers to significantly invest or reinvest in HoldCo on a *pari passu* basis. PE investors may also invest in quasi-equity/debt-like securities, such as convertible or redeemable bonds, to allow the managers to benefit from a wider portion of the share capital of HoldCo with the same investment amount (sweet equity mechanism). The manager can also be granted free shares of HoldCo.

Managers' investments may be directly in HoldCo, or indirectly in a dedicated company (ManCo) itself investing in HoldCo on behalf of the managers. Then, the managers can be granted free shares of ManCo (instead of HoldCo).

Carried interest securities may benefit to the PE investors' managers, allowing them to have a share of the capital gain achieved by the funds upon exit. Under certain strict conditions, favourable capital gains tax exemptions may apply to these interests. Otherwise, they are tax-treated as regular compensation.

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

Under VC transactions, PE investors usually take a minority shareholding in the target company (start-up company) to fund the development of its business and activities, which are not yet mature, alongside other types of investors (business angels or family offices, for instance). Such investment is riskier than a buyout transaction involving an already mature company.

Therefore, PE investors usually subscribe to complex securities, such as shares with ratchet warrants attached, granting either protection of their investment against failure of the target company to achieve its project, or the opportunity to participate in the next fundraising round at preferential conditions. The investment can also be made by subscribing to quasi-equity securities (so-called "BSA Air"), allowing PE investors to convert their securities at the next liquidity event (mainly fundraising round) under preferential conditions.

For PE investors taking a minority position, it is important to negotiate specific rights under a dedicated shareholders' agreement (e.g., specific voting rights, reinforced financial information, tag-along right, anti-dilution). In particular, PE investors can be granted veto or supervisory rights, either provided in the shareholders' agreement and/or the company's bylaws or attached to preferred shares subscribed.

In such situations, the management/founders remain the majority shareholders and may benefit from free shares or founders' options (so-called "BSPCE").

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 LBO transactions, the package offered to managers aims at aligning their interests with the financing parties' interests. The management is often requested to invest (directly or through ManCo) in HoldCo on a *pari passu* basis with the PE investor regarding securities, capital gain perspective, and exit horizon. As a matter of trend, the managers usually hold between 5% and 15% of the equity.

If it is intended to grant free shares (*actions gratuites*) to key employees/managers, such granting may not result in allocating more than 10% of the issued share capital, nor for any allocatee to hold more than 10% of the issued share capital. Such allocation becomes definitive upon the expiry of a compulsory vesting period (which cannot be less than one year), and – if the shareholders so decide – a holding period. The combined vesting and holding periods may not be less than two years. Some exceptions may, however, apply to the 10% threshold and the vesting/holding period (e.g., percentage can be increased up to 30% if the allocation of free shares is made to all salaried employees).

In VC transactions, BSPCE allocations are generally preferred. They must comply with certain conditions laid down in the French tax code. The BSPCE have no mandatory vesting and holding conditions or allocation cap, but market practice generally considers a four-year vesting period (with a one-year cliff) to be appropriate.

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

Usually, a resignation or a termination for any reason before an initial time period fixed with the financial investor, the termination of the manager's functions for gross or wilful misconduct or the violation of provisions of the bylaws or shareholders' agreement, are considered a bad leaver departure. When the departure results from an unintended event (death, invalidity, termination without cause) or when the resignation takes place after the expiry of the initial time-period, it is usually treated as a good leaver departure.

Good and bad leaver provisions are less prevalent following the recent decisions of the French Tax Court on management incentive plans (see question 10.4 below).

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 commonly structured as an SAS, benefitting from limited liabilities of shareholders and great freedom in corporate governance. The main drawback is that the shares of an SAS cannot be listed on stock exchanges – but the SAS can be converted into an SA just before an initial public offering (IPO).

A board with oversight powers is usually established to oversee the management, comprising members appointed by the investors (PE investors are generally reluctant that their nominees be provided with management powers). Subject to limited exceptions, the existence of the board, its functioning rules and the

identity of its members can remain fully confidential by being only stipulated in the shareholders' agreement. The board can also be disclosed or fully regulated in the articles of association of the company, which 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?

Board veto rights on major corporate actions are typically granted to director nominees of PE investors with significant shareholdings. PE investors holding only a few percentage points of share capital do not typically enjoy veto rights. This, however, mainly remains a matter of negotiations.

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 are rather uncommon at the shareholders level because usually organised at the board level through the members representing PE investors. Violations of veto arrangements are strongly sanctioned. Managers can be held liable for the breach and/or be dismissed. Should the breaching party be shareholder, the shareholders' agreement usually includes specific penalties, such as bad leaver clauses or financial sentences.

As a principle, limitations of management's powers (such as veto arrangements) are, however, unenforceable against third parties, even when included in the company's articles of association. This means that any transaction implemented by a manager in breach of a veto with a third party will remain valid, including if this third party was aware of such breach. Management decisions made in violation of veto arrangements can only be cancelled if: (i) they do not fall within the corporate purpose of the company, as stipulated in the articles of association; and (ii) the third party was aware – or, in view of the circumstances, could not have been unaware – that the decisions were beyond the corporate purpose of the company.

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?

All shareholders are prohibited from acting in their own interest for a purpose that goes against the company's interest and with the aim of negatively affecting other shareholders (*abus de majorité* and *abus de minorité*).

In addition, managers have, a duty of loyalty towards the shareholders, which originated from case law. This duty of loyalty is, however, restricted to information known by the manager and that is likely to have a significant influence on shareholders' consent.

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 can be drafted with extensive freedom. Still, they should refrain from derogating from the company's articles of association to avoid difficulties, and they must comply with public order provisions. Subject to the above, shareholders' agreements may include all types of provisions, such as non-competition and non-solicitation, which shall also comply with applicable case 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?

PE investors must always ensure that their nominees have the legal capacity to act as board members.

The liability of board members is mostly collective: should a decision made by the board be improper and a source of liability, all the board members are deemed jointly and severally liable unless they can prove that they behaved with proper care and opposed the contested decision. This mainly explains why PE investors sometimes avoid appointing representatives to the board. If they must do so, they generally require the portfolio company to subscribe to liability insurance covering the board members' liability (see question 11.6 below for insurance protection mechanism).

As far as PE investors are concerned, they are not exposed to liabilities as such, being shareholders, provided they do not excessively interfere with the company management and have not commingled their assets with those of the portfolio companies, otherwise their corporate veil of the limited liability may be pierced.

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?

French law provides a basic procedure to handle conflicts of interests from the angle of related-party agreements (*conventions réglementées*). However, this procedure is insufficient to deal with all conflicts of interest. We advise portfolio companies to set up internal rules regarding conflicts of 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?

Main issues impacting the timetable for French transactions generally are:

- before signing (binding agreement): prior-consultative opinion of the employees' representative bodies and/or prior information of employees (in companies with less than 250 employees qualifying as SMEs);
- before closing: clearances from (i) the French Competition Authority (Autorité de la Concurrence) or the EU Commission as the case may be, (ii) the AMF for listed companies, or (iii) the Ministry of Economy, Finance and Recovery in the case of investment in companies operating in sensitive industries; and

- usual practical issues, on a case-by-case basis, such as due diligence or financing structures (requiring equity and debt commitment letters with certain funds commitments).

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

While economic and geopolitical uncertainties are weighing on transactions in all Western countries, the French economy seems to show signs of resilience, even though there was a deceleration in PE activities in France in 2022, reflecting the reluctance of banks to finance certain transactions and rising interest rates.

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?

Although PE actors have expressed more interest in publicly listed companies (mainly due to lower valuation than non-listed assets), these transactions remain uncommon in France because the AMF will generally reject any offer conditional upon reaching the squeeze-out threshold. Indeed, PE investors would usually carry out public-to-private transactions by: (i) acquiring shares of the target listed company to reach the 90% threshold of the share capital and voting rights, typically by resorting to leverage; and then (ii) triggering the squeeze-out procedure to acquire the remaining shares of the listed company.

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

Unlike private acquisitions (see question 6.8 below), break fees are common in public transactions. The target can provide exclusivity undertakings to the bidder, but the board of directors must consider any offer from alternative bidders. Undertakings from key shareholders to tender their shares are also lawful, but they must be disclosed and automatically terminated if a competing bid is launched.

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 the completion accounts' structure remains the most used, the locked-box mechanism has become increasingly popular. Most of the transactions involving PE investors are based on locked-box whereas trade sellers generally use completion accounts.

Sellers tend to prefer the locked-box due to the simplicity and increased certainty of this mechanism, while purchasers tend to prefer the completion accounts, ensuring the price's accuracy. In situations where the closing date is expected to be very distant, the completion accounts mechanism makes more sense for all parties.

Regardless of price structure, deferred purchase price through earn-out clauses is common in PE transactions but is a breeding ground for 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 typically refuse to provide warranties and indemnities beyond fundamental representations (such as title to shares, power and authority, or the company's capital structure). Managers are usually key as part of the transaction. Negotiating warranties with them is a sensitive matter, and they tend to offer rather limited warranties to the buyer.

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

As a principle, PE sellers try to resist providing any kind of restrictive undertakings, but no leakage covenants in case of "locked-box" deals and undertakings in connection with the conduct of business until closing are typical. Managers are commonly bound by non-competition and non-solicitation undertakings.

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 & warranty insurance used to be very rare but has become much more popular, although there remains a significant margin for development. The cost and conditions of the insurance vary depending on target companies. We nevertheless notice that most insurance companies have their list of non-negotiable exclusions (e.g., criminal matters or risks identified in the due diligence) and that specific risks are excluded depending on the deal or target's industry.

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

Fundamental warranties are usually not subject to any limitations except a cap at the purchase price level. PE sellers and management teams usually refuse to be bound by other liabilities. If additional liabilities are necessary for the deal to go through (e.g., in the context of a purchase by a corporate buyer – see question 6.2 below), PE sellers and management teams will endeavour to restrict their liabilities as much as possible.

In the case of "locked-box" deals, any leakage will be recoverable from the sellers without a cap.

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 are strongly opposed to providing security, which is correlated to the fact that they are usually only liable for breach of fundamental warranties, which rarely occurs in practice.

PE buyers usually request extensive representations and warranties from sellers and the management team, backed by a security such as escrow accounts or first-demand bank guarantees. However, in the case of purchase from PE sellers, such

as in the context of a secondary buyout, the representations and warranties tend to be very limited and, accordingly, securities are very rarely provided.

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.)?

PE buyers can provide comfort regarding the availability of financing by providing the sellers, together with their binding offers, with equity and/or debt commitment letters with certain funds commitments.

The extent of the enforcement rights depends on the contractual arrangements with the banks and investors. Investors generally irrevocably undertake to fund the acquisition vehicle under equity commitment letters. If the acquisition vehicle is sentenced by a court to pay damages in case of default/breach of its contractual undertakings, as per the equity commitment letter, the financial sponsors will be required to pay said damages. This risk is, however, remote as French courts are reluctant to award significant damages.

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

Reverse break fees are not prevalent in the context of PE 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?

French IPOs are generally considered a time-consuming and costly process, subject to various legal and regulatory constraints and specific rules regarding acquisition or disposal of shareholdings.

French listed companies are also subject to higher scrutiny in terms of transparency requirements, including for corporate governance practices.

Sellers must pay particular attention to financial market conditions. French IPOs are subject to market fluctuations and volatility, sometimes leading to a delay or termination of the process due to insufficient pricing conditions.

In terms of sellers' rights, any existing shareholders' agreement would be terminated as a result of the IPO. Accordingly, sellers' governance, financial and other specific rights would not be maintained, and share transfers restrictions would be terminated. A new shareholders' agreement, including sometimes board veto rights and potential shares transfer restrictions (such as lock-up – see below), may be implemented post-IPO.

Regarding selling conditions, the company must declare in the IPO prospectus certain disclosures, based on which its shareholders may obtain indemnification post-completion in case of misleading disclosures.

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

Terms and duration of lock-up provisions vary depending on the company's particulars, market conditions and parties' negotiations, but sellers are generally asked to grant lock-ups for a duration varying from 90/180 days to 365 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?

In France, PE exits mostly occur through M&A transactions or secondary buyouts. Exits through IPOs have been limited on the French market in the past year and first trimester 2023 compared to 2021, mainly due to a shift in markets with inflation and rising interest rates, which explains why dual-track exit strategies are rarely pursued in France.

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 (including the syndicated loan market, private credit market and the high-yield bond market).

The most common sources of debt finance used to fund PE transactions in France are debts provided by traditional lenders (banks) through syndications or clubs. This financing generally involves various types of loans including term loans to refinance the company's existing debt and revolving credit facilities.

Other debt products are increasingly used to fund PE transactions (exclusively or in addition to traditional senior secured bank loans), such as mezzanine loans, uni-tranche financing, second lien loan and/or quasi-equity instruments such as bonds (straight bonds or bonds into shares).

Transactions can alternatively be financed by private placements and/or high-yield bonds provided by institutional investors, such as pension funds, insurance companies, and asset management firms.

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?

French law prohibits the acquired companies and their subsidiaries from providing any financing or granting any guarantee or security interest over their assets to secure the purchase or subscription of their own shares (financial assistance rules). Therefore, it is generally the acquiring vehicle that provides guarantees or security interests over its own assets (including the target company's shares) and sometimes downstream guarantees.

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

The reduction of banking monopoly prohibitions has led to a surge in competition among lenders in the debt-financing market in France. Furthermore, as interest rates are continuously

increasing in France over the last months, it became costlier for PE funds to borrow and leverage expensive LBOs. This mainly explains the increase in the number of private debt funds and alternative lenders, providing additional sources of debt to support PE investments.

Unitranche financings (providing a simplified debt structure, which combines senior and subordinated debt into a single facility) are also increasingly popular in France.

Environmental and ESG considerations have gained importance in the debt-financing market (certain lenders increasingly incorporating sustainability criteria into their investment decisions and financing terms).

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

General Partner (GP)-led secondary transactions (where GPs decide to sell one or more portfolio companies from a fund they manage to a new investment vehicle (continuation fund) managed by the same GPs) have been increasingly considered since the pandemic, mainly due to downward valuation trends. This deal structure, however, remains challenging to execute mostly due to difficulties in establishing a market price (allowing a return) and in dealing with management teams and investors.

9.2 Are there any particular legal requirements or restrictions impacting their use?

Before implementing this process, it must be ensured that the assets transferred to the continuation fund are free from any third-party rights (pursuant to any shareholders' agreement or similar) and that the consent of the primary fund's advisory board is secured. Certain customary provisions of the contractual documentation (including tag-along and drag-along provisions) must be adjusted to cover risks related to the use of continuation funds and conflicts of interests that may arise in connection thereof.

Managers must then identify which of the LPs are willing to sell and receive their sale price in cash or to reinvest all or part of their proceeds – before determining the valuation.

10 Tax Matters

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

PE transactions in France usually benefit from the combination of two favourable tax provisions:

- the buying and target companies may elect for the tax consolidation regime, notably subject to a minimum 95% holding requirement, under which: (i) the operational benefits of the subsidiaries are compensated with the tax losses usually incurred by the acquiring company; and (ii) the subsidiaries contribute the equivalent of the tax they would have incurred, had they not been included in the tax consolidated group, to the buying entity that can use that cash flow to pay the interest and/or principal of its acquisition loans; and
- interest incurred by the buying company, as well as acquisition and financing costs, are tax deductible even though dividends or capital gains derived from its investments are mostly tax exempt. Anti-hybrid measures, thin capitalisation rules and transfer pricing requirements may, however, limit the effective amount of deductible interest.

Buying companies are frequently activated (holding *animatrice*) to allow VAT recovery on acquisition costs.

Off-shore structures are expected to become less and less frequent, following implementation of several European directives including DAC6 reporting obligations and ATAD III measures against shell entities, and the evolution of domestic case law enhancing tax authorities' powers to discard foreign holding companies lacking substance.

10.2 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)?

Free share plans and, for start-ups, BSPCEs benefit from a relatively advantageous and, more importantly, reliable tax and social security regime.

Outside these regimes, a choice must be made between ordinary salaries, which are subject to high employer and employee social charges and up to 45% income tax, and capital investment, for which profits are only subject to a 30% flat tax (or an even lower one in certain investment plans (*plan d'épargne en actions*)). A 3% or 4% exceptional tax on high income may also apply in any case. Whilst very efficient, caution must be taken in structuring investment schemes aimed at applying the capital gains taxation regime, as these are often considered disguised remuneration by the French tax authorities, notably in the context of sweet equity schemes, preferred shares, deferred/vesting arrangements, or good/bad leaver put and call options.

10.3 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?

Rolling over part of their investment usually benefits from a tax deferral regime in the hands of the management teams, which can be a strong incentive. Selling shares triggers capital gain tax under the 30% flat tax regime; earn-out payments are usually efficient as they are only subject to tax when effectively due.

In the context of MBOs especially, the sale of shares to the new HoldCo by initial managers who retain a controlling interest in the new structure can trigger the application of an additional limitation rules, if a tax consolidation regime is implemented, on the tax deductibility of interest (*Amendement Charasse*).

10.4 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?

French tax environment has recently been relatively stable.

In 2018, business-favourable measures were adopted (e.g., the 30% flat tax on all investment income for individuals and the progressive reduction of corporate income tax).

PE deals were substantially impacted by recent decisions of the French highest Court on management incentive plans, which ruled that capital gains realised by managers qualify as employment income even when they invested money, at fair market value and at risk, if the gain realised is directly or

indirectly linked to the existence or execution of the employment/management contract. PE actors are thus increasingly turning to free share plans.

11 Legal and Regulatory Matters

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

The antitrust and foreign investment regulations have been enhanced over the past few years and now apply to a larger scope of transactions, including PE transactions. Further, recent French case law relating to the tax treatment of management packages may cause difficulties in PE transactions. Finally, the current trend for ESG considerations, the implementation of the duty of vigilance regulation in France, the issuance of the EU taxonomy and sustainable finance disclosure regulations (SFDR), and the forthcoming EU corporate sustainability reporting directive regulation (CSDR) are likely to drive PE investments.

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

As part of the growing interest in ESG considerations and the development of the socially responsible investment movement, PE funds are subject to further scrutiny regarding their application of the Taxonomy/SFDR regulations, which provide for a self-classification system to distinguish "green" investments from others. The AMF has recently issued proposals for a more rigorous regulation implementing at the EU level minimum environmental requirements, which financial products would have to meet to be classified as a green investment under Taxonomy/SFDR regulations to avoid any greenwashing practices.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

Impact investments are primarily regulated by soft law under which PE actors or companies are looking to comply with some labels, such as Bcorp label, which is awarded to commercial companies that meet societal, environmental, governance, and public transparency requirements, or GreenFin label, which guarantees the green quality of investment funds. However, under the influence of the EU, the impact investment sector is increasingly subject to hard law regulations.

11.4 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.)?

Usually, PE investors require full due diligence reviews before buyout investments but may fix different materiality thresholds depending on the reviewed areas. Such DD reviews may last from four to six weeks. Regarding VC transactions relating to early-stage companies, DD reviews may focus on specific areas, such as IP about tech companies, and are usually shorter (usually three to four weeks). Scope, materiality, and areas of the DD reviews may always vary from investor to investor.

11.5 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 French regulation has been strengthened over the past few years, including with the French act known as "Sapin II", which requires large companies to implement a compliance programme to prevent acts of bribery and corruption. The EU Commission is also currently seeking to harmonise the anti-bribery between all its members, by setting minimum standards. Therefore, PE actors are paying greater attention to such compliance, as is the case for ESG compliance/considerations.

11.6 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?

PE funds are careful and unlikely to exercise any management duties over the activities of the portfolio companies, to avoid attracting any liability (see question 3.6 above).

PE investors usually implement several protection mechanisms preventing them from being liable due to a breach of a portfolio company. HoldCo is usually incorporated under the form of a limited liability company. Further, the investor's representative may be appointed as a member of supervisory bodies within a portfolio company with limited powers, excluding any managerial power or function.

PE investors may require the portfolio company to, in any case, subscribe to liability insurance covering the members of its corporate bodies.

12 Other Useful Facts

12.1 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 the vein of France 2030 (i.e., a EUR 54 billion programme that aims at enabling France to close the industrial gap, invest massively in innovative technologies and support the ecological transition and the correlative French Tech label), French President Emmanuel Macron has recently announced a new EUR 500 million programme dedicated to artificial intelligence (AI). France intends to remain an attractive and active investment place in various sectors, focusing on tech, health, AI, and ESG-related sectors.

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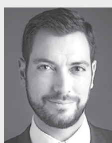

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1 Overview

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 majority of private equity transactions were private sales. However, P2P activity has increased, although only a limited number of takeover offers were ultimately launched. In addition, there have been a number of marketed minority investments. Growth transactions, i.e., acquisitions of shares in later stage financing rounds have slowed down compared to previous years.

Since the second half of 2022, all types of private equity and M&A transactions have slowed down in Germany, particularly large-cap private equity transactions in light of the higher debt financing costs. The number of equity-financed transactions also decreased, but not to the same extent, mainly due to lower valuation levels. Investments in distressed situations and transactions in which shares are used as transaction currency increased. Further, strategists continue to market carved-out business units that provide for private equity investors a primary situation.

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

Market activity and valuations have been negatively affected, both in Germany and globally, by not only macro-economic uncertainties and unfavourable financing conditions resulting from higher interest rates, but also the increasing global tension due to the war in Ukraine.

1.3 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 see an increasing number of co-investments of LPs in private equity-led transactions as well as family offices and industrial holdings that execute private equity style transactions. Key differences are a long-term investment approach as they often follow a co-entrepreneurial approach to develop the company together with founders/current owners and have no obligation to sell, more flexibility regarding majority or minority investments, and no or low level of debt financing. Usually, investments are sought in a few core areas in which the family office or industrial holding has significant industry expertise.

2 Structuring Matters

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

The acquisition of privately held companies is typically carried out by means of a share deal. If the target is a German limited liability company (GmbH), the underlying transaction documentation requires notarisation. For listed companies, the acquisition will be carried out on the basis of an offer document published by the bidder. If the shares are listed on an organised market such as the regulated market of the Frankfurt Stock Exchange, the offer document needs to be approved by the German Federal Financial Supervisory Authority (BaFin).

2.2 What are the main drivers for these acquisition structures?

Each individual acquisition structure is developed on a case-by-case basis. Key drivers are not only accounting and tax implications, but also legal and regulatory aspects as well as certain requirements from debt providers. Private equity sponsors further want to ring-fence each investment and, typically, already take the future exit and potential cash repatriation mechanisms into account at the time of the acquisition of the target.

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

Private equity funds typically establish an acquisition structure comprising several special-purpose vehicles (SPVs) incorporated in Germany and/or countries with a favourable regulatory and tax environment. These tailor-made acquisition structures are typically driven by accounting, tax, legal and regulatory aspects as well as the requirements of debt financing. They allow private equity sponsors to ring-fence their investments and facilitate future exit options and cash repatriation. While implementing different share classes at SPVs domiciled in typical holding jurisdictions such as Luxembourg and the Netherlands is common, equity of German holding companies usually comprises only ordinary shares, unless the economics of a management equity programme (MEP) require special shares such as preference, hurdle, or growth shares. Carry interest vehicles are usually established outside of Germany.

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

The structuring of the investment vehicles typically remains the same. In these situations, it is common that the private equity investor requires certainty on governance rights (e.g., representation on the relevant boards, veto rights, etc.), the timing of a potential exit, valuation protection throughout the investment, and other minority protection rights, such as 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?

The typical management equity pool can amount to up to 10% of the target's equity. Managers need to acquire their equity participation at fair market value to avoid upfront tax on fringe benefits. The management pool is usually subject to vesting rules. Common are time vesting schemes as well as, depending on the transaction, performance-based vesting rules. Private equity sponsors usually have the right to buy back the equity interests held by the management members once their employment or service agreements with the target group have ended or are terminated. Terms for such buy-backs, particularly the purchase price, usually take into account the circumstances triggering the exit of the respective manager (i.e., if the leaving manager is a good or bad leaver) and to which extent the manager's equity has actually vested.

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

It is quite common to distinguish between a manager's exit triggered by the participant, which generally results in a qualification as a bad leaver, and the good leaver scenarios where the sponsor or target wishes to terminate the employment or the participant otherwise ceases to work for the target. In the case of a termination for cause, the manager is typically qualified as 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?

Although the holding structure of a portfolio company may include various holding levels, at least the purchasing entity in German private equity transactions is usually a German limited liability company (*Gesellschaft mit beschränkter Haftung*, "GmbH").

A company in the legal form of a GmbH has one or more managing directors that are representing the company together. It is very common that the articles of association provide for a representation of the company by two managing directors, by a managing director together with an authorised officer (*Prokurist*), or by each managing director individually. The articles of associations are required to be registered with the commercial register (*Handelsregister*) and are publicly available.

The duties and responsibilities of the managing directors are usually further carried out in rules of procedure (*Geschäftsordnung*), which regularly provide for a catalogue of restricted matters that require the prior approval of the shareholder(s) or an (in most cases voluntarily established) advisory board. The rules of procedure are not publicly available. The legal implementation, however, very much depends on the legal form of the target company, in particular, whether it is a limited liability company or a stock corporation.

If any co-investors exist, the investors will most likely further conclude a shareholder agreement detailing the relationship between the investors and, in particular, outlining minority protection rights, exit scenarios, and conflict resolution mechanisms. The shareholders' agreement may require notarisation by a notary public, but is not 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, the implementation of restricted matters requiring the prior consent of representatives of the private equity investor is typical for private equity transactions. The catalogue of restricted matters in minority investments is usually shorter but also covers all measures that have a significant influence on the investment. Minority investors typically only have negative control rights such as veto rights on the restricted 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?

In case of veto arrangements contained in rules of procedure, the managing directors are, in general, legally not restricted in their power of representation to commit to such transactions towards third parties. Although the respective managing directors would be liable for such actions, the underlying transaction would be effective. If the target has the legal form of a stock corporation, consent requirements on major corporate actions can generally only be established at the supervisory board level, not at the shareholders level, and veto rights cannot be assigned to an individual supervisory board member.

Veto arrangements on shareholder level are simply contractual arrangements but may be unenforceable to the extent unlawfully limiting the statutory rights of a shareholder.

General restrictions to veto arrangements apply on the basis of the shareholder's and managing director's duty of loyalty towards the company.

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 shareholders of a GmbH have a duty of loyalty towards each other restricting them from harming each other. Other than that, the duties are being negotiated and contractually agreed, especially in the shareholders' agreement or in the management participation documentation.

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 relating to a German target would typically be subject to German law as well. In the case of the parties

agreeing to be governed by the laws of another jurisdiction, the provisions relating to the (transfer of) shares are at least required to be subject to German law.

Non-compete and non-solicitation provisions are, in order to be enforceable, required to comply with certain limitations in terms of scope, location and duration.

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

The risks and liabilities of a managing director nominated by the private equity investor are exactly the same as for any other managing director. Each managing director is fully responsible for the (day-to-day) management of the company and needs to act in the best interest of the company and in compliance with the law, the articles of association, the rules of procedure, and the resolutions of the shareholder(s), which may issue binding instructions to the managing directors.

Managing directors nominated by an investor are often not directly involved in the day-to-day management and try to limit their exposure with respect to personal liability by an allocation of duties (*Geschäftsverteilungsplan*). Although such allocation prevents them from being primarily responsible for the task and responsibilities allocated to other managing directors, their general supervisory duty remains. Further, there are certain key responsibilities that may not be allocated and remain as joint responsibility of the managing directors (e.g., the preparation of the annual accounts). Given this liability risk, it might be advisable to take a more passive role (e.g., as a member of an advisory board).

In any case, it should be ensured that appropriate D&O insurance coverage exists.

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 order to prevent the nominees from potential conflicts of interest, most private equity investors appoint their respective team members only to non-executive boards, such as the supervisory board or an advisory board. Supervisory and advisory board members are not involved in the day-to-day management and, thus, face fewer conflicts of interest.

As a result of the duty of care of a managing director towards the company, the managing directors must (always) act in the best interest of the company. Any potential conflicts of interest need to be disclosed to the shareholder(s) for evaluation.

In general, German law provides for self-dealing restrictions prohibiting representatives from legally binding a third party (such as the managing directors representing the company) on the one hand and concluding agreements with oneself or another third party on the other hand. The managing directors can, however, be released from such restrictions by the shareholder(s).

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 key impacts on the timetable for private equity transactions in Germany are:

- The due diligence process by a potential buyer and the resources of the seller/company to provide the appropriate information.
- Any discussions and negotiations on the provision of debt financing by third parties.
- Tax/structuring considerations and the acquisition and/or incorporation of the entities of the intended acquisition structure. It is common to acquire shelf companies in Germany from service providers.
- The negotiations of the transaction documentation (in particular, share purchase agreements and shareholder agreements).

Any required regulatory approvals. This commonly entails antitrust clearances and foreign direct investment approval. From July 2023, another approval requirement under the EU foreign subsidies regulation (*Drittstaatensubventionsverordnung*) will also become relevant, which applies in cases where the target has received any "financial contribution" from a non-EU member within the last three years.

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

The recent shift of the overall market situation to a more buyer-friendly environment has outdated the trends we have discerned in the past years.

5 Transaction Terms: Public Acquisitions

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

German capital market laws provide for strict rules to prevent the secret acquisition of stakes in public companies. For target companies listed on a regulated market, acquirers must disclose their shareholding after reaching thresholds of 3%, 5%, 10%, 15%, 20%, 25%, 30%, 50% or 75%. In addition, an investor is obliged to inform the target company about investment objectives and fund origin by reaching 10% of the voting rights. Outside regulated markets, only a threshold of 25% and 50% triggers corresponding notification obligations.

Once an investor has acquired a stake of 30%, the obligation for a mandatory takeover offer is triggered. Exceptions to such obligation can be granted on a rare case-by-case basis by the German Federal Financial Supervisory Authority (BaFin). Practically, private equity investors seek to avoid mandatory takeover offers and launch voluntary takeover offers instead before the 30% threshold is hit, thereby being more flexible to ensure that their particular structuring considerations reflect, for example, minimum acceptance rates or material adverse change clauses. Any takeover offer requires proof of availability of sufficient funds to execute the offer in order to obtain the required BaFin approval.

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

The private equity investor and the target can enter into a business combination agreement to support the takeover offer. Such agreements typically prohibit the target from soliciting competing offers ("no-shop" clause) or frustrating any offer conditions against the assurance of future management composition and employee retention.

In order to further enhance transaction security, it is common to seek agreements with major shareholders to irrevocably commit to tender their respective shares irrespective of competing offers, or not to tender their respective shares and sell them outside the takeover offer. These negotiations take place shortly before going public and are highly confidential in order to avoid any leakage.

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 various geopolitical uncertainties and the increased economic risks for companies have resulted in a comeback of closing account consideration mechanisms. In contrast to the locked-box mechanisms that have been standard for many years now in German transaction markets, closing accounts have the disadvantage that they lack purchase price certainty. Although this uncertainty results in increased complexity of the funding process of buyer's acquisition structure, they tend to prefer this administrative burden more and more as they are no longer willing to accept the risks associated with fixed purchase prices.

Sellers, however, perceive to achieve their desired considerations either in earn-out mechanisms that are strongly linked to the target company's economic performance in the years following the disposal or in an increasing number of a share consideration component.

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?

Naturally, any private equity seller that is seeking for a clean exit is trying to reduce the set of warranties and indemnities (W&I) as much as possible given the inherent liability risks. The minimum standard scope of warranties includes title to the shares, capacity of the seller and the unencumbered nature of the shares (fundamental warranties). The warranties relating to the business (business warranties) are subject to intensive negotiations.

Indemnifications in favour of the buyer are often provided with respect to tax matters or specific items that have been identified as risks during the due diligence process (e.g., environmental, compliance, or litigation risks).

The management team usually offers the same catalogue of warranties. In light of the future relationship, it is common to cap their overall liability to EUR 1 subject to W&I insurance coverage.

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 interim covenants for the time period between signing and closing as well as no leakage covenants for locked-box consideration mechanisms. Other covenants are negotiated on a case-by-case basis, in particular, in light of due diligence findings or regulatory requirements. The management team would typically provide 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?

W&I insurance is very commonly used. The strong competition between insurers has led to the availability of favourable terms at a moderate price level (0.8% to 1.5% ratio of the premium to the recoverable loss (ROL)).

The retention amounts typically vary in a range between 0.25% and 0.5% of the enterprise value. Policy limits vary between 10% and 30%. The policies exclude known risks identified in the due diligence or exclusions made in the scope of the due diligence.

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 share purchase agreement typically provides for various limitation periods with respect to different types of claims. Liability is further limited by *de minimis* amounts and thresholds/baskets. Typical limitation periods for fundamental warranties are two to five years, and the liability for fundamental warranty breaches is in the aggregate limited to the purchase price. Claims for breach of business warranties are typically limited to one or two years and capped at a certain percentage of the purchase price (or EUR 1 in the case of a "clean exit" with W&I insurance coverage). The common time limitation period for tax warranty claims is seven years.

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 fact that the use of W&I insurance has become common practice with private equity sponsors being on the sell-side as well as buy-side, the prevalence of escrow accounts or other security in such cases has decreased. Private equity buyers would typically only require an escrow component to mitigate a specific uninsurable risk that has been discovered in the course of the due diligence process.

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.)?

It is customary for private equity transactions in Germany that the sell-side will be provided with equity commitment letters and debt commitment letters to demonstrate the availability of "certain funds" required for the payment of the purchase price as well as any damage claims/break fees that may potentially be paid in the case of a broken deal after signing of the transaction.

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

They are not and have been rare, particularly before the COVID-19 pandemic. However, we have seen a growing number of reverse break fee provisions lately. The terms are typically a result of the negotiations on a case-by-case basis and heavily depend on the facts and circumstances of each 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?

It is customary in Germany that "lock-in" and "orderly market" periods prevent a swift and complete exit of a private equity seller. The high degree of regulation within the European regulatory framework further demands a significant preparation for several months. In addition, tax considerations pose a common challenge since private equity investments typically rely on Luxembourg or Dutch holding structures that prove unfavourable if sellers pursue the admission of a German entity. Before an IPO, tax-neutral reorganisation measures may therefore be required such as a tax-neutral merger of the previous foreign holding company with the German. In the event of a dual-track process, if the private equity seller shares more in-depth information with a bidder than provided in the prospectus published at a later stage, such bidder must be excluded from participating in the IPO.

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

On average, the underwriting banks demand a "lock-in" period of 180 calendar days following the listing. Carve-outs to such agreements are customary and provide private equity sellers with sufficient flexibility during the "lock-in" period. Transfers of shares to affiliates and pledges in connection with financing transactions, for example, are typically allowed.

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?

If private equity sellers pursue an IPO at all in the current market environment, a dual-track exit process is typical, particularly for large-cap transactions. The "point of no return" is not determined by law but rather individual circumstances. Generally, an IPO is abandoned more reluctantly after presenting information to a larger audience (e.g., after a roadshow). Yet, synergies for sellers substantially decrease once the due diligence process has been completed. Sellers indeed rarely disclose dual-track processes to avoid jeopardising the IPO by either demonstrating weak demand or a low likelihood of completion. Still, a trade sale remains the most common exit, without the latest drop in IPO activity.

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 (including the syndicated loan market, private credit market and the high-yield bond market).

The most common source of third-party debt used to fund private equity transactions remains the debt financing by way of a non-amortising term loan. The term loan financing is typically combined with a revolving credit financing. The revolving credit financing is available for general corporate and working capital purposes of the target group and is often treated, by the terms of an intercreditor agreement, as being super senior. In addition, where necessary for the ongoing business of the target group, capex and acquisition facilities are made available on a *pari passu* basis.

The term loan and capex/acquisition facilities are currently mainly provided by credit funds. Banks have significantly reduced their activities in relation to the term loan financing of private equity transactions. However, banks remain the main source for the revolving credit financing.

The term loan financing is often structured as a unitranche club deal where a wider loan syndication is not intended. Secondary loan syndications remain at a low level compared to previous years.

Compared to 2022, secured bond financings have increased and are mainly used to refinance maturing acquisition term loans.

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?

Compared to previous years, where transactions had been structured by using Luxembourg vehicles, private equity investors now prefer to use local vehicles for their acquisitions (in Germany, usually GmbHs). Creditors, on the other hand, remain focused on having a single point of enforcement. A single point of enforcement allows them to sell or to take control over the entire target group by the enforcement of one single security (typically a share pledge) at the level of one single security grantor. Since the enforcement of a German share pledge requires that the secured obligation have become due and payable, it is preferable for the creditors to obtain a single point of enforcement that is under the German borrower. In case the German borrower itself would be the single point of enforcement, a standstill would have to be granted or other measures would have to be taken in order to prevent the insolvency of the German borrower. Such an insolvency would significantly reduce to potential enforcement proceeds in relation to the pledged shares of the German borrower.

When acceding to the acquisition financing as additional guarantors and security grantors, the management of the target group companies will have to observe German law capital maintenance (*Kapitalerhaltung*) and liquidity maintenance (*Liquiditätserhaltung*) rules, which also apply to the granting of upstream guarantees and upstream security for the benefit of creditors of a shareholder. A violation of these rules can trigger a personal liability of management. In order to mitigate/exclude the described liability issue, it is market practice in German finance transactions to provide for contractual enforcement limitations in relation to the upstream guarantees and upstream collateral. Pursuant to such limitations, the enforcement is excluded to the extent that it would constitute a violation of the relevant rules.

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

Due to macro-economic headwinds, the origination of new acquisition financings has slowed down significantly in the first quarter of 2023. Private equity investors have been focused on the amendments and extensions of their existing acquisition financings. In that context, we have seen an increased willingness by private equity investors to provide fresh money in order to prevent or cure financial covenant breaches.

Since the beginning of the second quarter of 2023, we have seen a significant increase in relation to the origination of new acquisition financings.

Apart from pricing, which is higher than in previous years, private equity investors continue to benefit from favourable loan terms, which provide them with a high level of flexibility.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

The relevance of secondary transactions in Germany is increasing in line with the global trend. Continuation funds have become a way for GPs and their investors to hold on to companies longer rather than selling them in depressed market environment. Contrary to their reputation as "zombie funds", the sale of strong assets particularly provides an attractive benefit/risk profile economically.

9.2 Are there any particular legal requirements or restrictions impacting their use?

In general, continuation funds are subject to the same legal framework as other alternative investment funds. Legal restrictions may, in particular, arise in connection with the permanent conflict of interest that exists in the context of transactions in which the private equity sponsor acts on both the buy-side and the sell-side.

10 Tax Matters

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

Investors typically use an acquisition structure comprising several special-purpose vehicles incorporated in Germany and/ or countries with a favourable investment environment for private equity and M&A investments (typically Luxembourg, the Netherlands or the Channel Islands). Typical tailor-made investment structures for German deals allow for a tax-efficient acquisition of a target group considering the following key tax aspects:

(i) Exit considerations (sale of shares, IPO, etc.) and optimised capital gains treatment as part of an exit scenario.
(ii) Tailored repatriation mechanisms together with a financing structure (considering a mixture of equity and debt financing) serving the investor's needs.
(iii) Optimised overall tax position by allowing to offset target group's operating profits with acquisition financing costs by implementing tax grouping schemes.
(vi) Survival of tax attributes (such as tax loss carry forwards and current year losses) to protect against historic tax risks and to reduce the future target group's tax burden.
(v) Optimised real estate transfer tax position.
(vi) Investment opportunities to incentivise management (MEP, virtual share programme, etc).
(vii) Opportunity to on-board co-investors to share the investment risk and to further leverage the investment structure.

Besides structural needs, W&I coverage for historic tax risks becomes more and more popular in German deals. Having said this, a sophisticated and aligned tax due diligence scoping is required to allow for sufficient historic tax risk coverage. Identified tax risks as part of tax due diligence are more often covered by special tax insurance to the extent there is no recourse against sellers under special tax indemnities.

10.2 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 incentivisation through participation in the future value creation of a target group plays a crucial role in most private equity transactions. Such incentive schemes can be structured either as co-investments through (indirect) participation of the management in the target's equity or as simple contractual arrangements, essentially entitling management to a bonus payment or virtual share options should certain key milestones be achieved. While contractual arrangements are easier to implement and more standard in M&A transactions, it is more common for private equity sponsors to offer (senior) management the opportunity to co-invest in the target with own money (MEP).

In an MEP, typically a mix of preferred instruments and ordinary shares (indirectly) held by management will usually govern the management's risk and return profile. So-called growth shares (only entitling holders to the value creation after their acquisition), hurdle shares (providing holders with value participation once a certain hurdle is achieved) or ratchet shares (entitling holders to a certain return) could be considered. Tax risks associated with these kinds of special shares are, however, even higher than in a common structure comprising a mix of preferred and ordinary instruments only. In any case, the treatment of the underlying MEP returns under the tax preferential capital gains regime is key for management.

Management's investment is regularly pooled in vehicles in the form of a tax-transparent partnership being controlled by the sponsor. This kind of indirect investment structure allows sponsors to establish, among other things, appropriate governance.

Sponsors regularly have the right to buy back the equity interests held by the management members once their employment or service agreements with the target have ended or have been terminated (leaver schemes differentiating between good leaver and bad leaver). Such leaver schemes are usually aligned with the overall vesting scheme and tag-along/drag-along rights of the MEP.

10.3 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?

Sale and roll-over of management (*pari passu*) investments/ equity must be considered carefully by an in-depth upfront structuring on the management's sight. Typically, the management re-invests based on net profits after tax to the extent a tax-neutral re-investment/roll-over mechanism is not available or compliance efforts and resulting holding periods attached to such tax neutral roll-over are too burdensome.

The most common way to entitle management to a later tax-efficient sale or tax-neutral roll-over into the new sponsor's structure is to bundle management's equity in a German corporation. Such pooling allows, on the one hand, benefitting from

the tax-preferential German capital gains exemption (*c.* 1.5% tax on capital gains), in the case of an exit scenario and, on the other hand, benefitting from tax neutral roll-over schemes (share-for-share exchange).

10.4 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?

- Increased substance requirements and recent international developments such as the EU's second Anti-Tax Avoidance Directive (ATAD 2) and the so-called Unshell Directive (on rules to prevent the misuse of shell entities for tax purposes) have had a relevant impact on how funds as well as their investments are structured.
- Real estate transfer tax regulations have been tightened recently with additional compliance and filing requirements.
- Tax audits focus more and more on transactional tax matters such as transfer pricing aspects in the light of financing activities, substance requirements, treatment of transaction costs, and transaction bonuses.

11 Legal and Regulatory Matters

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

The regulatory framework (in particular, relating to foreign investment control) has changed multiple times of the last years. The most recent example for additional regulatory requirements is the introduction of the EU foreign subsidies regulation (*Drittstaatensubventionsverordnung*) regarding the receipt of "financial contributions" from a non-EU member.

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

Private equity funds (*et al.*) registered in the EU are subject to Directive EU 2011/61/EU, the Alternative Investment Fund Managers Directive (AIFMD), a regulatory framework established to protect investors and reduce the risks imposed by such funds to economies.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

Impact investments, e.g., infrastructure projects, can be subject to various specific legal and regulatory requirements that are and will be dynamically changing in the current environment. The legal framework in the EU further provides for certain regulations and directives concerning ESG-relevant topics that have gained massive relevance in the past years.

11.4 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 comprehensiveness of each due diligence process varies a lot depending on the requirements of the concrete transaction such as size of the target, valuation, type of investment or needs of the buyer.

For complex auction sales, the conduction of a comprehensive vendor due diligence by sellers (through their advisors) is still very common in order to structure and simplify the process. As buyers will most likely not get reliance on the vendor due diligence report from sellers' advisors, they are typically conducting an additional buy-side due diligence in order to confirm its results.

In less complex or bilateral situations, private equity sponsors are regularly adjusting their due diligence to the requirements of debt providers or W&I insurance. It is not common to apply rather high materiality thresholds and focus on items with particular commercial relevance.

11.5 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.)?

Legal compliance topics in general have become a standard due diligence item and are regularly covered in-depth within the business warranties. This applies not only to anti-bribery and anti-corruption laws, but also to anti-money laundering or other areas of legal compliance (e.g., data protection).

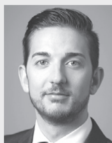
11.6 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another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

The liability risks of investors could be based on the grounds of contractual arrangements or fraudulent behaviour. Further, there have been court decisions by the European Court of Justice (EuGH) confirming the joint and several liability of an investment fund together with one of its portfolio companies for a violation of anti-trust laws. Although there have not yet been similar decisions by German courts referring to such EuGH decision, a similar ruling concerning a German investment could be possible in light of the European legal framework.

12 Other Useful Facts

12.1 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 environment for private equity transactions in Germany is still highly attractive. Private equity investors have significantly improved their reputation as responsible investors for the benefit of the economic viability of the companies, their respective employees, and the economic area. As private equity investors have been shown to achieve particularly strong returns in periods of economic uncertainties and Germany still has a large number of attractive technology leaders as well as small and mid-sized businesses, it is likely that private equity investors (both domestic and international) will remain very active in German transaction markets.



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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 2022, EUR 250 million was invested into Hungarian companies through 184 transactions.

According to the annual Investment Monitoring Report prepared by the Hungarian Private Equity and Venture Capital Association in collaboration with EY, 198 investments were executed by Hungarian investors either in Hungary or abroad (22% lower than in 2021) for a total value of EUR 220 million, which represents a 62% increase compared to 2021, showing a significant increase in individual investment value.

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

A strong, unpredicted and never-seen-before factor for PE transactions in Hungary, the whole of CEE and even Europe is the Russian-Ukrainian war. The war has generated extremely strong economic effects: significant increases in material and energy prices; disruption of supply chains; corporate difficulties or insolvency; and general inflation and insecurity. These factors combined to trigger a process whereby investors and companies seeking investment, even if fewer in number, remained in the market, sought more investment outside the traditional banking and bond markets.

Given the relative proximity of war and Hungary's border with Ukraine, expectations have come to the fore that investment (mainly foreign) in Hungary will be on a sharp downward trajectory in 2022. Fortunately, these expectations have been dashed and, as the statistics show, PE investment value is showing a strong increase compared to 2021, a year that was hampered by the COVID-19 pandemic.

Hungary has already proven to be a credible and growing market for international and domestic players. The growth potential is still great in CEE and Hungary ranks among the top four countries in PE activity.

The availability of the European Union (EU) and domestic funds and their attractiveness to PE 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.

Contrary to expectations, as seen in the statistics, the Russian-Ukrainian war had no significant negative impact on Hungary's foreign PE activity. Apart from a decrease in the fourth quarter of 2022, despite the war, high inflation, rising interest rates and high energy costs, the PE activity remained high and even increased in volume compared to 2021.

1.3 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 "zrt."s, i.e. companies limited by shares, or "kft."s, 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 an 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 three to six 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.

Regarding the foreign direct investments (FDI) regime, 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, European Economic Area (EEA) or Switzerland is considered a foreign investor.

Investors should also be aware of indirect investments of foreign entities, where the foreign entity is the majority controller of a non-foreign investor entity.

Pursuant to the act, a foreign investor may acquire more than 25% (or 10% in 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.

Another part of the Hungarian FDI regime is the so-called 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 Economic Development beforehand.

For the purposes of the regulation, foreign investors are private persons and legal entities domiciled outside the EU, 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 regulation 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 regulation may result in a fine up to two times the value of the relevant 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 warranty and indemnity (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 (including the syndicated loan market, private credit market and the high-yield bond market).

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, debt financing is much more common. Unfortunately, debt financing is becoming more expensive due to the termination of the Hungarian Central Bank's policy of keeping interest rates low, which has been the principle for the past several years.

The syndicated loan market in Hungary is relatively small, but it is certainly available and there are a few syndicated loans every year with varying amounts. In 2022, the largest syndicated loan in the market was USD 200 million.

The private credit market is expected to be on the rise as a new amendment to Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises creates the opportunity of granting convertible loans on a limited basis within the meaning of the act on SMEs and the support of their development up to a maximum of 15 times in a calendar year, provided that the aggregate amount of the loans granted does not exceed HUF 500 million in the case of natural persons and HUF 2 billion in the case of legal persons. If one happens to make a loan that violates these rules, there is a significant risk that the Hungarian Central Bank could deem this as non-licensed lending activity, which would violate the licensing requirements and would mean certain negative consequences such as significant fines being imposed on the lending entity.

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; however, the interest rates have been on a steep rise in recent months as the Hungarian Central Bank terminated its long-lasting policy to keep interest rates low. This factor is mainly driven by the Russian-Ukrainian war and is expected to be the new principle.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

Although continuation fund vehicles and GP-led secondary transactions are theoretically possible in Hungary, there is

currently no significant market practice in this field. The transfer of assets between funds is possible, but rarely used and the general purpose of such transfers is not to perform a GP-led secondary transaction, but to perform a general exit of the investment.

9.2 Are there any particular legal requirements or restrictions impacting their use?

There are no additional legal requirements and restrictions, nor case law regarding continuation funds or GP-led secondary transactions, due to the fact that these kinds of deals are not known to Hungarian market practice.

One applicable (but not specific) requirement is that, during the winding-up procedure of the fund, assets in the portfolio of the venture capital and private equity fund are sold within 18 months. The time limit set for the sale may be extended by three months in the case of financial assets and by six months in the case of real estate and other assets, subject to the approval of the Hungarian Central Bank for the benefit of investors.

10 Tax Matters

10.1 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.

10.2 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.

10.3 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 13% 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.

10.4 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 several times and is currently 13%. The current tax cap on social contribution payment is currently HUF 723,840 for the year 2023.

11 Legal and Regulatory Matters

11.1 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.

11.2 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.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

Although impact investments make up only a small part of the total investment value in Hungary, Hungary is still ahead of its neighbours in this field. Hungary was the first country in the CEE region to set up a social impact investment fund in 2018.

The general market expectations are that impact investments (including ESG investments) are going to rise in the near future; however, market players must ensure that the real impact investments can be fully distinguished from investments and investment funds that only use "impact" as a marketing catch to attract investors.

Currently, in Hungary, there are no additional legal requirements that are specific to impact investments. Certain entities of public interest are obliged to disclose a non-financial statement in its annual report containing information on: the entity's policies; the faced risks and risk management procedures regarding environmental, social and employment issues; respect for human rights; and the fight against corruption and bribery,

to the extent necessary for an understanding of the development, performance, position and impact of the company's activities.

11.4 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.

11.5 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.

11.6 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.

12 Other Useful Facts

12.1 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?

Hungary is as an attractive market for PE investments in the region, as reflected in the relevant market statistics mentioned above.

Although the main factors that PE investors should consider when planning to invest in Hungary have already been discussed in the previous topics of this chapter, the frequent changes of the transitional rules adopted with regard to the pandemic, Russia's war on Ukraine or the energy crisis might pose an additional risk to investors.

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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?

Similar to the west, the most common type of private equity transactions that are prevalent in India are minority, growth and buyout transactions.

Further, certain sectors, such as healthcare (hospitals and pharma), infrastructure (especially, green/clean energy) and technology, have continued their dominance, and will continue to remain every investor's favourite sectors over the course of the next 12–24 months at the very least.

In addition, impact investments have gained significant traction, and many funds have floated separate impact investment affiliates with such investment focus.

Although due to the significant rise in inflation and the resulting increase in global interest rates, private equity leveraged buy-out transactions have seen a significant decline in the west, India has demonstrated resilience for private equity transactions for three primary reasons: *first*, because it has always been a straight equity investment jurisdiction with only a few funds using structured overseas intermediary lending structures; *second*, because India is now looked at as a real alternative to China based on, among other things, preferable regulatory environment, depth of investment opportunities and proven exit/return history; and *third*, a lot of private equity funds have significant dry powder with none or limited country allocation limits, and therefore, significant allocations have now been diverted to India.

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

In addition to those discussed in question 1.1 above, the following factors encourage the ongoing investment trend:

(i) stable political regime and facilitative investment environment, including continued relaxations in foreign exchange regulations governing inbound investments;
(ii) increased enforceability of investment agreements and effective bankruptcy regime; and
(iii) the exit aspirations and diversification mindset of the first- and second-generation promoters, respectively.

Some of the key inhibiting factors are:

(i) certain restrictive regulatory approval requirements for FDI from bordering countries;
(ii) certain tax fair market value related changes that may result in additional tax liability for targets; and
(iii) the current slowdown in IPO related PE exits.

1.3 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, the impact investment funds, sovereign wealth funds ("SWFs") 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 short-term time-bound return of capital related outlook. The holding period results in subtle differences in the structuring of transactions, governance and exit rights 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 and growing preference for such investors. In addition, it is also now a common practice for SWFs to co-invest directly in the target to have direct access (as compared to tiered), individual (as compared to derivative or collective) governance and exit rights, and better return economics.

As per the database of the Sovereign Wealth Fund Institute, the direct investment by SWFs in India increased from USD 3.797 billion in 2021 to USD 6.712 billion in 2022. India witnessed some notable investments by SWFs in 2022, which included Abu Dhabi-based Mubadala Investment Company's investment of INR 40 billion along with BlackRock Real Assets in Tata Power Renewable Energy Limited and Qatar Investment Authority's investment of USD 1.5 billion in Bodhi Tree Systems.

Similarly, impact investment funds focus substantially more on specific environmental, social and governance ("ESG") diligence, extensive representations, warranties and undertakings with respect to ESG as a part of deal documentation, with continued focus on best ESG practices after the investment and on certain investment sectors, such as clean/green energy infrastructure transactions.

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 or through one or more of the following modes:

(i) acquisition vehicles: through the traditional route of investing directly, through special purpose vehicles ("SPVs") incorporated in tax and investor-friendly jurisdictions, or trusts registered as alternative investment funds;
(ii) investment routes: as either FDI, foreign portfolio investments ("FPI") or foreign venture capital investments;
(iii) investment instruments: by way of equity or preference shares, shares with differential voting rights, or partly paid shares and/or other equity-linked convertible instruments (such as warrants, compulsorily convertible preference shares or compulsorily convertible debentures); and
(iv) acquisition structures: by way of share acquisition, business transfer, asset purchase and/or merger, demerger or amalgamations. Shares of a public listed entity can also be acquired by triggering a voluntary offer/mandatory tender offer ("MTO").

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 for foreign investors. Accordingly, structuring to ensure compliance with Indian regulations while achieving investment objectives is the main driver. In addition, the key structuring considerations are: (i) tax considerations; (ii) return expectations; (iii) investment horizon; and (iv) any specific demands or conditions from the 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 private companies in India to have several classes of equity or compulsorily convertible instruments, which can eventually be converted into equity securities. The classes of securities progressively decrease from private companies to listed companies. Equity for management personnel (except promoters) is typically provided in the form of 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 to facilitate exits along with the majority stakeholders. Such protections are classically structured as limited affirmative veto rights, anti-dilution rights, liquidation preference, information and audit rights, observer rights and certain negotiated transfer restrictions *vis-à-vis* other 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?

Whilst not mandatory, the management is typically allocated equity in the form of ESOPs or warrants. Promoters are not permitted to have ESOPs. The ESOP vesting or conversion conditions are agreed on a case-to-case basis and usually linked to performance/exit conditions. 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 or without cause, and where termination is undertaken in compliance with the terms of his/her employment arrangement. Contrarily, a bad leaver leaves without notice and/or for cause.

Given that it may be difficult to classify persons as good leavers/bad leavers at the outset, it is common to give the board of directors (the "Board") the discretion to make this determination and/or capture such definitions in the relevant employment agreements.

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 the shareholders' agreement, which typically provide the following governance arrangements:

(i) appointment of the agreed number of nominees on the Board;
(ii) mandatory participation of the nominees to form quorum in meetings of the Board and shareholders;
(iii) affirmative veto rights on identified matters;
(iv) information, inspection and audit rights; and
(v) policies and procedures to be implemented by the portfolio companies.

These arrangements are not required to be made public; however, these are usually included in the articles of association of the relevant portfolio company for the purposes of enforceability, and such articles of association 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, typically PE investors and/or their director nominees are contractually entitled to veto rights at Board and shareholder meetings, as agreed under the shareholders' agreement. These include, among others, changes to the business plan, acquisitions and divestitures, financing and capital structure-related matters, entry into strategic partnerships, etc.

Depending on the minority position, the list of the veto rights may vary. Minority investors typically negotiate limited veto

rights on critical matters such as, among others, changes to constitution or capital structure, matters regarding liquidation, alteration of constitutional documents affecting their rights, etc.

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

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, like any other directors on the Board, have certain fiduciary duties, including to: (i) act in good faith to promote the company's objects; (ii) act in the best interest of the company, its employees, shareholders and the 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.

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 tribunal 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 to be the law governing the substantial obligations set out under the shareholders' agreements, to facilitate enforcement of provisions in respect of, or *vis-à-vis*, the company. However, even where a shareholders' agreement is governed by foreign law, in a dispute scenario, the arbitral 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 terms of period and scope) 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 companies law prescribes certain qualifications and conditions to be fulfilled prior to a person being appointed as a director on the Board. Further, companies law also prescribes requirements regarding resident directors, women directors, independent directors and limits on the maximum number of directorships that can be held by a person. Furthermore, the government has issued a notification that requires mandatory security clearance of proposed directors in Indian companies prior to being appointed, if such person is a citizen of any of India's land-bordering nations. These conditions are generally applicable and are not specific to PE investor nominees.

Directors, including PE nominees, are liable for statutory breaches, especially where they can be shown to have breached their fiduciary duties or where they had actual knowledge of the breach. 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 the 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 to lift the 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.

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 time taken for transactions primarily depends on the nature of the investee (listed/unlisted) and the mode of acquisition. Acquisition of private companies is comparatively quicker compared to that of public companies, followed by acquisitions through schemes.

Some of the key issues that commonly impact the timetable for transactions in Indian deals are:

(i) the timelines for obtaining regulatory approvals (from the Government of India (in case of investments from bordering countries or from entities with beneficial owners from bordering countries), the Reserve Bank of India ("RBI"), the Securities and Exchange Board of India ("SEBI"), the Competition Commission of India and other sector regulators, as the case may be) vary on a case-to-case basis and are often unpredictable;

(ii) the timelines for obtaining approvals or sanctions that involve courts or tribunals in India may take inordinately long; and

(iii) often, on the basis of the due diligence conducted, the seller is required to obtain contractual consents from third parties prior to consummation of the transaction, and buyers include measures for the investee company to rectify past non-compliances/regulatory lapses as pre-completion conditions to the transaction, all of which have an impact on the timetable.

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. There is a growing trend of investors having equal or, in certain cases, even greater management rights than the founders. There is an increased focus on thorough due diligence for every transaction, which often includes specific ESG, anti-bribery and anti-money laundering ("ABC/AML") and tax diligence. Further, trends such as break fee and reverse break fee provisions are also starting to gain prominence, although these largely remain untested from a regulatory perspective. Payment structures such as locked-box mechanisms, deferred payments and escrow arrangements are also gaining popularity, as well as the increasing use of 'hell or high water' clauses as a remedy to complete mega mergers.

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: (i) the requirement that the majority of public shareholders must approve such transaction; and (ii) 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 and may also take a long time to consummate.

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

Indian law is premised on the 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.

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 (such as a share swap) 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. On the buy-side, investors may opt to defer payment of part of their consideration. Foreign investors are permitted to defer up to 25% of the total consideration, 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?

PE sellers generally provide limited representations and warranties to the buyer in respect of their title to shares, authority, capacity and solvency. Indemnities are, accordingly, limited to breach of these representations and warranties only. In addition, PE sellers may agree to a specific indemnity for identified breaches, with negotiated terms on quantum, trigger thresholds, etc. PE sellers are generally keen on hassle-free exits, and do not typically provide any business warranties on the grounds that they were financial investors and not in active management.

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 and the sellers upon breach. These include, the scope of warranties, as well as limitations and exclusions for indemnities, which are often heavily negotiated. Use of representations and warranties insurance ("RWI") policies for acquisition and exit transactions is now more common than it used to be a few years ago.

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 in terms of conduct and state of operations of the investee company 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 material 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 and is now more common than it used to be a few years ago. RWI policies are generally co-terminus with the survival period for claims. 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 3–8% of the policy limit. Additionally, parties must bear a specified 'retention amount' before the 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?

For competitive auctions, we have seen RWI policies as the sole recourse for buyers. For those transactions that do not include such policies, the most common limitation concerns the quantum of liability and the claim periods. Parties negotiate and set out the thresholds for *de minimis* and aggregate liability. 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.

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 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. We have also seen sophisticated acquirers requiring a backstop from private equity sellers exiting through an SPV in certain situations and even negotiate for equity commitment letters ("ECL") from such 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.)?

Leveraged buyout transactions are generally prohibited in India, unless such leverage is structured overseas, and therefore most transactions are structured without any financing outs and as straight equity investments.

There is no general statutory obligation on PE buyers in private acquisitions to provide any financing comfort. 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 obligations are simultaneous with the seller's obligation to transfer securities.

Some sellers may insist on an ECL from PE buyers, especially when they invest through SPVs. Common rights of enforcement available on breach include indemnity, specific performance 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?

There are no provisions for payment of reverse break fees under law; however, this can be agreed contractually. Typically, the terms include those in respect of quantum, trigger for payment, mode of payment, etc. Due to the absence of an express legal regime, effecting payment of reverse break fees from a resident to a non-resident may face regulatory hurdles, such as obtaining RBI approval prior to payment.

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) The lock in period of pre-IPO securities held by promoters and non-promoters is 18 months and six months, respectively, from the date of allotment and subject to further conditionalities.

(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 (other than promoters) are statutorily locked-in for a period of six months from 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?

In the financial year 2022–23, approximately INR 52,116 crores were raised by 37 Indian companies, through IPOs. While this is a dip since the numbers in 2021–22, the first quarter of 2023 witnessed a 33% increase in the number of IPOs in India as compared to the same period last year. Therefore, IPOs have been the preferred exit path; although many deals nowadays are structured as dual-track deals, benchmarking purposes prior to the IPO run-up and/or a full-exit are preferred by PE investors.

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 (including the syndicated loan market, private credit market and the high-yield bond market).

Funding through privately placed non-convertible debentures ("NCDs") is a popular form of debt financing. Funds can be raised through 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 the 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 must be listed. 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?

There is a decreasing interest of investors in instruments like rupee-denominated (masala) bonds. As such instruments are denominated in Indian rupees, overseas lenders are expected to bear the risk of exchange rate fluctuations. Accordingly, masala bonds are not popular among PE investors. SEBI continues to make amendments to protect investors of listed debt securities and enable debenture trustees to perform their duties more effectively.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

While GP-led secondaries were traditionally not seen favourably, these are now being considered in the Indian context, especially to continue investments in assets that can yield higher returns in the future.

9.2 Are there any particular legal requirements or restrictions impacting their use?

The formation and allocation towards continuation funds has its own set of legal, tax, regulatory and governance complications. The structures of such funds should be considered and analysed in the context of the rollover LPs, the assets being continued and the advantages of leveraging an existing structure as compared to setting up a new investing vehicle.

10 Tax Matters

10.1 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. Further, Indian tax laws contain general anti-avoidance rules, whereby Indian tax authorities have the power to deny tax benefits if the arrangement does not have commercial substance and its main purpose is to obtain tax benefits.

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

Most PE investors use the traditional route of investing directly or through SPVs. 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.

10.3 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.

10.4 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. Under Indian tax laws, a private company is assessed to tax on share premium upon issue of shares in respect to the consideration received from a resident if the consideration exceeds the fair market value of the shares. Recently, under the Finance Act, 2023, the scope of applicability of angel tax has been widened to include non-resident investors. With this, companies issuing shares above fair market value to non-resident investors will also now fall within the ambit of angel tax. Some of the other key changes brought about by the Union Budget 2023 includes the extension of tax incentives for start-ups, extension of concessional tax rates on

domestic manufacturing companies, taxation of online gaming and increase in withholding tax rates on payment of royalty and fees for technical services.

11 Legal and Regulatory Matters

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

(i) In 2020, India introduced mandatory government approval for foreign investment from countries sharing its land borders/investors whose ultimate beneficial owners were citizens of, or situated in such countries. This is principally aimed at curbing Chinese investments and potential takeovers in light of the pandemic-induced slowdown. Subsequently, investments that would otherwise be automatically permitted now fall under the approval route if the PE investor has a 'beneficial owner' from any of India's bordering countries.

(ii) In June 2022, India introduced the mandatory security clearance of persons who are citizens of India's land bordering countries prior to such persons being appointed as directors on the Board of Indian companies. This is aimed at reducing the backdoor control of Chinese investors in Indian companies.

(iii) The Indian Supreme Court has also ruled that two Indian parties are 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.

(iv) FDI thresholds in sectors such as insurance, telecom and defence have been further liberalised.

(v) Recently, by way of a notification in May 2023, the Finance Ministry has also included practicing chartered accountants, company secretaries and cost and works accountants carrying out financial transactions (such as buying and selling of immovable property, managing client money, securities and assets, operation or management of companies, etc.) on behalf of their clients within the ambit of anti-money laundering laws.

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

Transactions involving foreign investment from India's land bordering countries/investors whose ultimate beneficial owners are citizens of, or situated in such countries requires prior regulatory approval.

In the last few years, another significant development has been a disclosure requirement of beneficial ownership for all companies. While this is not specific to PE investors, it mandates all Indian companies to investigate their ultimate beneficial owners and make appropriate public disclosures.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

SEBI had introduced social venture funds, as category-I alternative investment funds, with relaxed investment conditions to enable investors to primarily invest in social ventures and social enterprises. Further, SEBI has also put in place a legal framework for the issue of green bonds.

11.4 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 the investee company prior to investing. The scope, materiality and timeframe for diligence varies with each transaction, depending on the nature and sector of the investee, mode of acquisition, the transaction timetable and the approvals required to be obtained.

Generally, the scope of the legal diligence 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 and litigation.

11.5 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 investors are now increasingly undertaking specific due diligence for evaluating the investee company's compliance with domestic ABC/AML laws as well as internal standards. There is also a growing (and recommended) trend of engaging specialists to undertake such diligence. Separately, investors also seek wide warranties and undertakings from the investee company, founders, sellers (in a secondary transaction), and their immediate relatives, in respect of compliance with ABC/AML laws, their past and present conduct, the relationship with government officials, etc.

11.6 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 a director, to the extent he/she had knowledge of the breach. Under Indian 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.

12 Other Useful Facts

12.1 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?

With Indian laws on foreign investment, securities and corporate management being complex and constantly evolving, investors must engage qualified local legal, financial and tax advisers at the inception of every transaction, leading to unavoidable cost expenditure, even for transactions that eventually fall through. The Indian judicial process, with its uncertain timelines, has been a concern; though investors invariably choose arbitration for dispute resolution. Lastly, while investors have been concerned about the lengthy timelines taken to obtain regulatory approvals in India, we are now able to provide estimated timelines for obtaining these, which is reassuring to investors.

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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 developed, similar in its features and dynamics to other sophisticated European markets. It encompasses a significant number of global, US, pan-European, and domestic private equity firms and other alternative providers of private capital of different sizes and types. These players carry out all types of transactions and are able to meet all the industry's different needs. At the end of 2022 (according to the Italian Private Capital Association "AIFI"), private equity players owned in their portfolios about 2,000 Italian companies for an aggregate value of about EUR 70 billion, 46 of which referred to international financial sponsors.

Nowadays, private equity represents a fundamental, strategic, and transformative part of the Italian economy and financial and corporate landscape, linking the worldwide-recognised Italian family-owned entrepreneurship with transnational and international financial and trade markets.

The appetite of private equity and venture capital investors for the Italian market during 2022, in contrast with global and European trends and in line with the 2021 Italian M&A frenzy activity, peaked again and at unprecedented record levels (compared to the historical market data for the Italian private equity market) both in terms of deal value and volume. Also, the upstream fundraising activity has been in line with – or higher than – the activity of the record year 2021.

This is in spite of the deep escalation of the ongoing war in Ukraine, which has been compounded by dealmakers' worries about the persistent deceleration of global economic growth (also due to the combined effect of the energy and commodities price crisis, persistence inflation, rising interest rates, public debts, etc.), the disruption of the international trade activity, together with the reshaping of the multilateralist post-cold-war world order and its ensuing clashes between democracies and autocracies.

Notwithstanding the deceleration of the global economy, the Italian economy, relative to Italian historical data, for the first time in several decades, had a growth rate higher than that registered by the other large European economies in 2022 equal to 3.7%. However, it has been forecasted that the GDP growth should return to a more modest 1.2% in 2023.

Looking at investments quantitative data, according to AIFI, during 2022, a staggering 848 transactions (approximately), involving 624 companies, were completed by private equity investors for the unprecedented total deal value of about EUR 23.66 billion, with a remarkable increase of 30% in deal volume and 61% in deal value (thanks to some buyout and infrastructure mega deals) *vs* the (so far) record year 2021.

More specifically, 2022 private equity activity has been mainly fostered by the venture capital/early-stage sector with 547 transactions executed (including the relatively new niche in the Italian market of corporate venture capital) followed by the buyout sector with 185 transactions executed while the infrastructure sector registered 52 executed transactions.

As per 2021, also in 2022, the buyout and the infrastructure sectors have been the most relevant sectors for the Italian economy in terms of deal value by registering the respective amounts of EUR 10.95 billion and of EUR 10.69 billion. On the contrary, the early-stage sector deal value has been equal to EUR 1.1 billion.

Moreover, during 2022, there was a surge in the private equity pivotal phase of divestment (whereby private equity firms are looking to realise a sizeable capital gain with a good return on their investments), with approximately 117 divestments completed involving 94 portfolio companies (+13% *vs* 2021) for a total value of EUR 4.3 billion (+63% *vs* 2021).

Traditionally in the Italian market, the exit phase has been predominantly carried out through the exit mechanism of a trade sale to industrial buyers. However, in 2022, and for the first time, the most predominant exit mechanism has been the trade sale – or secondary sales – to other private equity buyers (i.e. 47 executed exits for a deal value of EUR 2.6 billion) followed by a trade sale to industrial buyers. This rise in secondary sales can be considered a sign of the maturity phase reached by the private equity industry in Italy. The remaining 2022 divestments have been carried out through sales to founders or family offices, and, to an extremely limited extent, by initial public offerings ("IPO") and de-SPACs, and, finally, in some cases, write-offs or involuntary exits.

Italian private equity activity in the first five months of 2023 has continued its transformative development and, despite the increasing social, economic and geopolitical global concerns, it has been resilient and in line with the 2022 activity (unlike the wider M&A activity, which suffered a slowdown in its pace of activity). Indeed, as of May 2023, the Italian private equity market registered the execution of 164 transactions (i.e. 10 transactions more than those executed in the same period of the year 2022), including several add-on investments – predominantly in the mid-market sector (which are considered strategic for the characteristics of the Italian corporate landscape) – while there have been fewer large deals.

The above data demonstrates the enduring confidence of international and domestic dealmakers and of the global M&A crowd *vis-à-vis* the Italian M&A market.

In 2022 and H1 2023, there were no major changes in the implementation of the structure of private equity transactions and, to this end, financial sponsors usually continued to use in the structuring of their investments a combination of equity, quasi-equity and debt instruments; together with a preference to acquire, directly or through portfolio companies, the control of a target company, and minority deals (usually combined with quasi-equity instruments), this has been increasingly popular.

Some trends and features relating to deal structuring can be highlighted: (i) a relative increase in sale auction processes and competition between financial sponsors and strategic/corporate investors; and (ii) co-investments, club deals or "consortia" between private equity firms (or between private equity firms and strategic investors or State-owned or -sponsored investors) becoming more common in Italy, particularly with regard to blue-chip buyout deals in the infrastructure sector, 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 ("W&I") policies within the context of buyout transactions; (iv) an increase in re-investment(s) by the seller/founder(s) of the target alongside the private equity investors in the special purpose vehicle; and (v) an increase in private investment in public companies ("PIPE") transactions, as well as in public-to-private ("PTP") transactions that have been, relative to Italian standards, quite significant in their numbers, notwithstanding the characteristics and limited number of available 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 market is generally considered by international and domestic financial buyers an attractive market. It is characterised by a large number of potential primary transactions, relatively few (but increasing in number) sale auction processes and a vast spectrum of appealing targets, often at more advantageous valuations than other more mature private equity markets.

More specifically, the Italian corporate landscape and economy, which is the second European manufacturing powerhouse, includes a multitude of small, mid and large successful family-owned companies (few listed ones) with a particular focus on exports and international markets, active in highly specialised sectors, with a skilled and trained workforce. The "Made in Italy" brand plays a pivotal role, too. Therefore, this market somewhat represents a unique and fertile land for domestic and foreign financial sponsors, other alternative capital providers and M&A dealmakers that focus their investment appetite on both small and mid-size companies (often through add-on and buy-and-build transactions) as well as large private or listed companies. Vast opportunities remain in place for Italian family-owned-businesses of any size or listed companies willing to open their shareholdings to private equity investors. In this sense, there is a renewed positive attitude by both family-owned businesses and Italian governmental authorities towards private equity (and private capital), which, in some years, might be transformational for the development of the country's economy and for the Italian private equity's industry.

Private equity investors are traditionally more active in the north of Italy, followed by central Italy, while the south of Italy records only a relatively limited number of investments.

In particular, the Lombardy region and the city of Milan attract most cross-border inbound investments.

As to other factors that may encourage private equity transactions in Italy, it is worth emphasising that the Italian government in 2021 set forth a National Recovery and Resilience Plan ("NRRP"), mostly financed by the European recovery plan known as "Next Generation EU", which is involving funds for more than EUR 220 billion over a five-year period (2021–2026). The implementation of the National and Resilience Recovery Plan is ongoing and should be mostly carried out, notwithstanding several difficulties in its actual implementation by the National and local authorities. It seems that such reforms are starting to have a positive boost on the overall Italian business and economic environment, including cross-border overall M&A activity and private equity. Cross-border M&A activity continues to be a crucial driver for the Italian economy, traditionally largely influenced by global economic and trade trends and foreign direct investment ("FDI") flows (generally coming from the United States, France, the United Kingdom, Luxembourg and Germany).

Finally, there is an abundance of private equity dry powder for investment in Italy, and private equity transactions, particularly in buyouts in mid-market sector, will probably involve a reduced amount of debt finance with a moderate leverage, thus with a reduced risk for traditional banking or private debt facilities.

1.3 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 appearance and surge of global private equity houses and conglomerates (often formerly pure hedge funds), as well as other new types of strategic and financial buyers, e.g.: pension funds; large family offices; sophisticated, large cross-border club deals; corporate venture capital; and sovereign wealth funds.

In addition, the Italian market in 2022 also experienced the rise and activism of small private equity investors (entrepreneurial club deals and other informal syndicates of investors), with a persistent spill-over of outbound and inbound cross-border M&A transactions and private equity buyouts, as well as more structured 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 and an alternative to financing. 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, the Italian market, in line with the US and global market, registered – also in 2022 – a correction in de-SPACs transactions, due to the difficulties faced by the overall capital market sector.

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 and, in particular, Luxembourg) holding company ("HoldCo"), and sometimes also a mid company ("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 10 (Tax Matters).

2.2 What are the main drivers for these acquisition structures?

Private equity acquisition structures are traditionally driven by tax and financing issues, as well as some ownership features. For further details, please refer to sections 8 (Financing) and 10 (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 in either 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 10 (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 typically seek: specific protections, such as veto rights/super majority provisions on certain matters (e.g., extraordinary transactions, transactions with related parties, strategic decisions – including relevant investments, disposal of material assets or appointments of certain executive roles, etc.); the possibility to designate "watching dogs" in the board of the target – or sometimes, to designate "their own" directors, specific information rights on the activity of the management body of the company and access rights. The so-called "waterfall provisions", which address the priority and timing of the distribution of capital upon occurrence of certain events, are common too.

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).

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 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 specific events (including good or bad leaver events).

Management's ownership is also usually subject to lock-ups and other share transfer restrictions and managers are usually bound by significant 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 generally determine the consequences in terms of price of the management equity in the case of departure of the manager or impossibility for the latter to serve on his/her role.

The most common events of good leaver are death, mental/physical incapacity preventing the manager from continuing serving on his/her office, retirement, and revocation without cause. A good leaver event might trigger a call option in favour of the investor (or a put option in favour of the manager) at a strike price not lower than the market price.

On the other hand, any case of revocation with just cause (*giusta causa*) usually represents a bad leaver event, which might trigger a call option in favour of the investor at a strike price lower than the market price.

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?

As a preliminary overview, it is worth noting that Italian companies are allowed to choose between 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/employees 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 between 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 were adopted by a very few companies (mostly listed). In light of the above, the answers below only make reference to the traditional model.

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.

In Italy, there is no obligation to disclose and/or make available shareholders' agreements, unless those agreements concern listed companies. However, in case corporate arrangements are also mirrored 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 rather 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 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 targets, etc.). That being said, the actual range and type of vetoes required by a minority investor depends on the purpose of the investment (as well as of the type of investors) since certain investors are mainly interested in receiving a return on the investment, while others might be seeking to be more involved in the management of the portfolio company business. The first type of investor would be keener to "enjoy" waterfall protections and dividend preferences than vetoes on managerial decisions.

Should a private equity investor acquire a controlling stake, the vetoes above are 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 contained in shareholders' agreements, which are enforceable as contractual obligations binding upon the signatories unless they are also reflected in the by-laws – to the extent permitted by the law. However, in order to avoid severe 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 considered. The ultimate deadlock resolution mechanism is the so-called "Russian roulette" or "cowboy" 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 its validity has been confirmed only recently 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 scrutinised the validity of a Russian roulette clause inserted in a shareholders' agreement. The Court of Rome ruled on the legitimacy and validity of the clause. Three years later (on February 3, 2020), the decision was also upheld by the Court of Appeal of Rome.

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 decision, the majority shareholder shall always act in good faith and pursuing the corporate benefit. The majority shareholder shall also 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, on the contrary, minority shareholders shall not abuse their position (for instance, in case the by-laws of the company provide for a veto right 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 five years; 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 withdrawal right.

Furthermore, according to Italian law, holders of the same class of shares should enjoy the same rights; therefore, it is common for joint-stock companies to issue different classes of shares to which different rights are attached. The limited liability companies are much more flexible on the matter and the "same class of shares same rights" tenet does not apply to these entities.

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 and subject to antitrust scrutiny.

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 the office 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 directors of a limited liability company, which can serve the office until revocation or departure.

However, it is also worth considering that: (a) the by-laws of the companies could include specific requirements to be met to serve as director; and (b) certain types of companies (those subject to the supervision of regulatory authorities, such as banks and insurance companies), directors and top managers shall meet specific requirements provided by applicable *ad hoc* regulation (in terms of reputation, professionalism and independence).

The risks and liabilities of directors designated by a private equity investor are exactly the same that directors designated by any other shareholder might face. Directors shall serve their office: (i) acting in accordance with applicable law and the company's by-laws, to pursue the corporate purpose and in accordance with the corporate benefit principle; (ii) with the diligence required by their position and based on their specific skills and knowledge; (iii) acting in an informed manner; and (iv) not taking any decision that might conflict with the interests of the company. On the other hand, directors are protected by the "business judgment rule" test.

Directors may be liable towards (a) the company, (b) the company's creditors, and (c) the company's shareholders.

Furthermore, it is worth mentioning that, potentially, a shareholder could be held liable for the underlying portfolio companies if, in exercising its "direction and coordination" activity over its subsidiary, it causes damages or losses to the company. The "direction and coordination" activity over a subsidiary is presumed upon the occurrence of certain conditions, such as the management bodies of the directing company and the controlled company including the same persons and the steady stream of instructions that the directing company provides to the controlled company's directors. Please also refer to the answer to question 11.6.

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 position (on his/her or a third party's behalf) with respect to the adoption of a certain corporate resolution, he/she shall declare the conflict and explain such conflict before voting. A resolution passed with the decisive vote of a conflicted director can be challenged by the other directors or by the 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 (the enactment of the Annual Antitrust Law in August 2022, strengthening the Italian Competition Regime by providing new powers and tools to the relevant Authority) and/or regulatory authorisations/approvals/clearances, as well as the completion of unions' procedures.

In addition to the foregoing, Law Decree no. 21/2012, as subsequently amended (the "Decree"), has gradually extended, also in light of EU Regulation no. 452/2019, the scope of the governmental rights to veto or impose prescriptions on M&A and private equity transactions concerning target companies or assets operating in specific sectors that are considered to be strategic under the FDI screening regulation (so-called "golden power" regulation), such as defence and national security, energy, transport, communications, health, water management, semiconductors, cybersecurity, agri-food, banking and insurance, high technology, sensitive data, aerospace, electoral infrastructure, dual-use products and media.

It is worth noting that, for certain sectors (energy, telecommunications, transports, health, banking and financial services, agri-food), a mandatory authorisation by the competent authority (i.e. the Presidency of Council of Ministries) for FDI purposes could be required not only in case of extra-EU investors, but also in case the purchasing party has EU (including Italian) nationality. Furthermore, for extra-EU investors, the acquisition of non-controlling shareholdings representing more than 10% of the share capital or voting rights of a company operating strategic activities or assets are also subject to FDI authorisation.

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).

Private equity transactions might also be subject to the control of independent sectorial authorities in accordance with the sector and industry of the target object of the buyout, e.g.: Bank of Italy and the European Central Bank in the event of financial institutions and banks; Insurance Supervisory Authority ("IVASS") in the event of insurance companies; Communications Authority ("AGCOM") in the event of telecommunications companies; and the National Commission for Companies and the Stock Exchange ("CONSOB") in the event of listed companies. Finally, said transactions may be subject to the clearance of the Italian Antitrust Authority or the relevant European authority in the event of such transactions triggering the relevant Italian or EU clearance thresholds. Recently, on 12 January 2023, the Foreign Subsidies Regulation (Regulation EU no. 2022/2560) entered into force, with the purposes of addressing distortions caused by foreign subsidies. More specifically, it relates to the investigation by the European Commission (also on its own initiative) on financial contributions granted by

non-EU States to companies engaging in economic activity in the EU with the aim to redress their distortive effects, if needed. Among other things, such regulation provides some obligations to notify to the Commission concentrations or participations in public procurement procedures involving a financial contribution by a non-EU government.

In relation to FDI, including private equity investments, the Italian legal system also set a general principle of reciprocity by which the Italian authorities could challenge an M&A transaction if there is no reciprocity with the relevant foreign investor's jurisdiction. Accordingly, this set of rules shall not be considered in the event of EU and EEA countries, together with those countries that have signed bilateral investment agreements with Italy or that have, in any event, a reciprocity in dealing with the Italian entities.

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

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 2022 Annual Report about Golden Power (FDI) proceedings shows that, in 2021, 496, and in 2022, 608 notifications have been carried out, of which 314 have been made as a precautionary measure. Of the above-mentioned cases, 519 concerned strategic sectors (including energy, transport and communications in addition to the sectors covered by the European regulation), 71 defence and security, while 18 concerned 5G technology.

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 (a total of 414) for a capitalisation of approximately EUR 626 billion, as of 23 December 2022: 223 companies are listed on Euronext Milan, i.e., the Italian regulated main market; 190 companies are listed on the Euronext Growth Milan; and one company is listed on MIV Investment Vehicles (all figures are correct as of the end of December 2021). Public M&As in Italy have been relatively dynamic throughout 2022, with 29 IPOs (a contraction of more than 40% against the 49 IPOs registered in 2021), consisting of no. 3 IPOs on Euronext Growth Milan and no. 1 direct listings. In this context, public M&A has been dynamic in terms of deal volume, with 19 tender offers for a value of EUR 2.94 billion – and often with the outcome of delisting (about 16) – signalling the use of tender-offer mechanisms in the Italian market not as a mechanism for the so-called corporate control (as in the case of the US and UK capital markets), but mainly for the so-called PTP transactions in a market with limited contestability opportunities, whereby the ownership structure of most Italian listed companies is still characterised by strong major anchor blocks of shareholders.

With reference to applicable laws, Italian PTP 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 CONSOB (i.e., the Italian authority regulating and supervising companies listed in Italy and Italian securities markets, including PTP 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 exercises over an Italian public company shall be carried out in compliance with the provisions of the Market Abuse Regulation. In particular, although much information concerning a listed company is available to the public by operation of law, bidders usually want to conduct a due diligence exercise prior to launch a public tender offer. However, insider trading provisions and rules prohibiting selective disclosure of price-sensitive information, which are contained in the Market Abuse Regulation, often cause significant concerns as to the limits within which due diligence reviews preceding a public tender offer may be safely conducted without (i) qualifying the bidder as an "insider" (with consequent limitations and restrictions), and (ii) exposing the target to the risk of being sanctioned for having disclosed material information only to the bidder (and not to the general public). The issue under (ii) above is such that the target's directors are often quite reluctant in allowing the due diligence exercise. Another legal issue/limitation for the target's directors is that they may proceed with the disclosure of information to the bidder, only if that is in the best interest of the target company. The satisfaction of such interest is usually reached if the proposed transaction would allow a maximisation of the share value of all of the target' shareholders. Based on the above, while no due diligence access is allowed in a hostile bid scenario, it is not uncommon that the target provides the bidder(s) with details on all the public information in its possession as well as certain non-privileged/non-price-sensitive information that is not known by the public.

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 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 in 2020 and 2021 and, moreover, with the deep escalation of the ongoing war in Ukraine in 2022 and 2023, compounded by the global economic growth deceleration and international trade disruption.

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?

Many transactions have been pursued using the so-called "locked-box" mechanism. The use of such structure is dependent upon various elements, such as: (i) the time between the date on which the investor has priced the target and the closing date of the transaction; (ii) the type and quality of document produced by the company/seller that the investor used to price the business (e.g., audited financial statements *vs* financial statements *vs pro forma* balance sheet); (iii) the entity certifying or auditing such document; and (iv) the predictability of the business (and cash flow) carried out by the target. Any difference in the finances occurring between the date on which the buyer "locked the box" (the so-called "locked-box date" or "reference date") and the completion date is considered a "leakage" and discounted from the purchase price. The distribution of dividends, related party transactions, change in the remuneration policies, or transaction's fees – just to name a few – are common examples of leakages.

The above being said, buyers seem more comfortable with the closing-accounts structure, while a major certainty of the purchase price embodied in the locked box makes this mechanism preferable for sellers. It is also quite common, especially when the finances of the target depend on general market conditions or somehow have a high degree of unpredictability, to have a mix of locked-box and closing-accounts mechanisms.

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 generally tend to offer a very limited package of representations and warranties. In addition to the "legal" warranties, which are mandatory by law (these warranties, which are not really negotiated, relate to the signatory powers and the ownership title over the shares subject to sale), the most accepted warranties are those that cover tax and labour matters – those warranties are also usually referred to as "fundamental" warranties. Indemnity obligations arising from the breach of legal warranties are usually accepted to last until the expiration of the relevant statute of limitation, while with respect to the fundamental warranties sellers generally accept to be "on the hook" for a maximum between five and seven years. The time limitations concerning warranties other than legal and fundamental are definitely shorter and fall within a range of a 12–18-month time period.

The representations and warranties of the management tend to be aligned.

In very general terms, private equity sellers deliver fewer representations and warranties than industrial investors and tend to negotiate a very small indemnification cap (around 10–20%); uncapped indemnities (in some deal proposed to cover legal and fundamental warranties) are not easily accepted by private equity players.

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 a transaction does not provide for a simultaneous signing and closing, interim period covenants take effect in respect of the transaction documentation. The interim covenants ensure: (i) on the one hand, that between singing and closing the target is managed in a manner consistent with past practice – but always with the intention of not freezing the business of the company and losing value; and (ii) on the other hand, that the transition to a new ownership (or co-ownership) goes as smoothly as possible.

Other covenants usually requested by, or to, private equity sellers are: (i) specific indemnities, to indemnify the purchasers from any red flag specifically spotted during their due diligence exercise; or (ii) non-compete undertakings on the top management of the sellers involved in the business sold.

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

Representation and warranties insurance policies ("W&I Insurance") have been widely used in private equity transactions in recent years, although many operators are still suspicious of this instrument. The resistance of certain operators to W&I Insurance is not completely groundless, since:

1. several insurers do not offer coverage (or provide very little coverage) for specific business;
2. W&I Insurance does not cover: (i) issues identified during the due diligence process or arising from matters that have not been properly assessed or inspected by the beneficiary during the due diligence; or (ii) certain representations and warranties, such as environmental matters, anti-corruption matters, secondary tax liability, and product liabilities;
3. W&I Insurance is still quite expensive, even if the cost depends on the indemnification cap, the coverages sought by the beneficiary and other specific requests to the insurers. In addition, the fees for the legal advisor of the insurer and the broker shall be paid upfront;
4. the underwriting process is quite articulated – although a well-committed broker can be very helpful – and, sometimes, this does not fit with the timing of a deal quickly moving towards closure; and
5. the insurers leave very little room for 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); basket (around 10–20% of the cap); and *de minimis* (which is expressed by an amount); and (b) exclusions, such as losses resulting from change of laws occurred after closing, events fairly disclosed during the due diligence or caused by an action or omission of the buyer. Time limitations for general representations and warranties range between 12 and 18 months. Private equity sellers tend not to deliver uncapped indemnities, neither in terms of amount nor timing.

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)?

Should W&I Insurance be executed, private equity sellers do not generally provide additional guarantees. In the absence of the above policy, a corporate guarantee or an equity commitment letter from a company belonging to the seller's group might be delivered.

Private equity buyers, on the other hand, usually request first demand bank guarantees or an escrow to guarantee the fulfilment of the seller's indemnification obligations.

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 generally 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 seller's right to trigger the guarantor's obligation to provide equity, upon the occurrence of certain conditions (and failure of the buyer to fulfil them).

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 set forth 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. Along the lines provided by applicable regulation and the guidance of the European Securities and Markets Authority, an IPO prospectus distinguishes between the characteristic risks of the issuer, those linked to the sector to which it belongs and those relating to the transaction itself of listing the company on the stock exchange and the securities being offered.

Moreover, from a corporate governance standpoint, the IPO process requires 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 (just to name a few areas in terms of independent directors, gender equality and committees).

A significant step forwards in the Italian IPO market that facilitates such an exit strategy for international private equity sellers is that the Commissione Nazionale per le Società e la Borsa, the Italian securities regulator, from August 2022, allows issuers to file a prospectus exclusively drafted in English (with the exception of the summary note, which needs to be in Italian). This is a significant game-changer on the path to the market in

Italy. Mid and large corporates such as Lottomatica, Ferretti and Eurotech have already opted for English as their prospectus language. This seems to be a market trend for the future.

Another recent development is the growth of Euronext Growth Milan, the multilateral trading facility organised and managed by the Italian Stock Exchange, which started off as being primarily focused on small deals with very limited volatility, and has now turned into a more solid platform for larger issuers (which could include companies owned by private equity firms). A new trend, which reflects the higher dimension of the companies accessing such market, is the use of English as the language for the admission document. In this case, the admission document is not technically a prospectus, as defined pursuant to the applicable EU Regulation, and does not require the official approval of the local securities regulator. Recent examples of such approach are Technoprobe and the upcoming listing of Maggioli, with an expected market capitalisation exceeding Euro 400 million.

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

Although there are no legal requirements relating to lock-up arrangements or their term in connection with an IPO exit, market practice is that Joint Global Coordinators usually request sellers to commit to a lock-up period ranging from six to 12 months (starting from the IPO date). It should also be noted that the lock-up period is usually longer for: (i) 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; and (ii) companies that are in substance start-ups, particularly in the technology sector. In such cases, lock-up periods of up to 24 months have been negotiated.

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.

In such context, additional attention is also given in case of incentive plans already in place or to be implemented upon completion of the IPO to ensure that key executives are also considered for lock-up coverage.

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 as it enhances the successful outcome of the exit strategy. The decision to move forwards with a sale or the IPO is usually taken before the approval by CONSOB for the publication of the prospectus and ultimately depends on the price offered by the potential buyers and capital market conditions. There have been cases in which the IPO process was cancelled immediately prior to CONSOB's approval and theoretically a decision to cancel the IPO and complete a sale is possible also after the publication of the approval, but prior to the notification of the allocations upon completion of the book building process in the IPO context.

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 are indeed less prone to spend resources to concurrently prepare for both an IPO and a third-party exit.

In the context of a dual-track process, any communication or information provided to private investors invited to participate in the competitive bid, irrespective of the means chosen to convey them (e.g. oral, in writing, by means of digital data) or of the stage of the competitive bid, is subject to transparency and equal treatment principles (in line with those of the addressees of the IPO), and must be consistent with the information contained in the IPO prospectus.

In order to ensure compliance with such principles, it is necessary that, in the context of the dual-track process, information flows are carefully monitored, ensuring that the information made available to private investors is the same information provided to the addressees of the IPO and contained in the IPO prospectus. Therefore, it appears appropriate that adequate "gate keeping" controls be set up, directly involving the legal counsel assisting the issuer, as well as the investor relator, to continuously monitor the information flows ensuring the highest level of coordination and consistency in the approach between the IPO and the M&A sale.

Should any information different from or additional to that made available in the context of the IPO be provided to private investors in the context of the dual-track process, it will be necessary to supplement and/or amend the IPO prospectus in order to disclose the new information to the market, unless, after careful evaluation and subject to confirmation from the legal counsel, such information is deemed not to be material to investors in the context of the IPO.

It should be noted that, if material information other than or in addition to that made available to the addressees of the IPO is disclosed, private investors who become aware of such information should refrain from trading on the market involving the issuer's securities until the inside information is made public (so-called "cleansing"). In this case, private investors should sign specific confidentiality commitments covering such matters and their implications. Breach of the duty to refrain from trading in the company's securities could entail criminal charges for the person who unlawfully used inside information, pursuant to Article 184 of the Italian Security Act, as well as the liability of the Issuer and/or shareholders who have unlawfully disclosed inside information, pursuant to Article 187-*bis* of the Italian Security Act and Article 14 of the Market Abuse Regulation.

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 (including the syndicated loan market, private credit market and the high-yield bond market).

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 with the support of private debt providers by means of bond issuance due to regulatory restrictions and the recourse to mezzanine financing, unitranches and vendor loans is also growing.

However, in larger transactions, acquisitions are also frequently financed through a combination of senior and mezzanine debt, unitranches or senior debt and high-yield 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 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 regulatory aspects, financial assistance and corporate benefit issues.

Regulatory provisions implies that only banks and other authorised entity can enter into debt loans, while non-authorised entities (such as the most part of the private debt funds and other institutional investors) provide financing by means of bond notes, having specific requirements imposed by Italian laws.

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 debt push-down 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) where, until the merger, the acquisition debt is likely to be supported only by means of a share pledge over the NewCo, 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 could also benefit from further 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 2023, the global increase of the costs of the debt financing and inflation caused a significant slowdown in the M&A market, with banks and other traditional financers taking a conservative approach, becoming more selective in the participation and tickets on the deals. This has led to a significant increase of private debt and unitranche financings – more expensive, but quicker in the delivery.

We have also seen an increase in the refinancing, add-ons and bridge financings aimed at consolidating capital structures already in place (and maybe in initial financial tensions), where the lenders seem to gain more contractual powers on the borrower and be able to obtain more robust credit risk protection (such as in terms of security package) than in the recent past.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

In recent years, we have seen a significant growth in continuation funds and GP-led transactions. This is generally true for funds targeting their term of duration and is also driven by the public markets' volatility and uncertainty.

9.2 Are there any particular legal requirements or restrictions impacting their use?

In continuation fund vehicles or GP-led secondary transactions, the fiduciary duties and regulatory conflict of interest rules applying to Italian AIFMs will come into place.

In particular, Italian AIFMs are required by law to act diligently, correctly and in a transparent manner in the best interests of the AIFs they manage, their investors and the integrity of the market.

Inter alia, they must: (1) be organised in a manner that minimises the risk of conflicts of interest and, in the event of a conflict, ensure the AIFs they manage receive fair treatment; and (2) adopt appropriate measures to safeguard the rights of the investors in the AIFs they manage and have adequate resources and adopt appropriate procedures to ensure efficient performance of their services.

Given that the Italian AIFM is on both sides of the deal in such transactions, the AIFM would need to comply with its fiduciary duties and regulatory conflict of interest rules, implementing internal processes and structure to manage and monitor these conflicts of interest.

10 Tax Matters

10.1 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, 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 beneficial carried interest regime.

10.2 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 somewhat 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".

10.3 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 terms, 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.

10.4 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 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. Similar 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 (including anti-hybrid rules) and the EU Directive on administrative cooperation 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 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.

The 2023 Italian Budget introduced the investment management exemption ("IME"), a provision according to which the investment management activities carried out in Italy by asset managers should not give rise to a permanent establishment ("PE") of the foreign investment vehicle (or its subsidiaries) if certain conditions are met.

Specifically, an Italian or foreign tax resident asset or investment manager operating in Italy, which habitually concludes (or contributes to the conclusion of) contracts for purchasing, selling or negotiating financial instruments (including derivatives, shares and receivables) in the name and/or on behalf of the foreign investment vehicle (or its subsidiaries), would not constitute a PE of the latter to the extent that:

- the foreign investment vehicle and its subsidiaries are resident in white-listed jurisdictions;
- the foreign investment vehicle satisfies the independence requirements indicated in a Decree to be issued by the Ministry of Finance;
- the Italian or foreign tax resident asset/investment manager operating in Italy is not a member of the foreign investment vehicle's (and its subsidiaries') administration and control bodies;
- the Italian or foreign tax resident asset/investment manager operating in Italy is not entitled to more than 25% of the foreign investment vehicle's economic results;
- the Italian asset/investment manager or the Italian PE of the foreign asset/investment manager receive an arm's-length remuneration supported by appropriate transfer pricing ("TP") documentation (Italian tax authorities' guidelines will be issued).

This legislation, as has happened in other jurisdictions that have adopted similar provisions, should provide more comfort to the investment management industry willing to locate all or part of their activities or managers in Italy.

11 Legal and Regulatory Matters

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

Italian laws implemented Directive 2011/61/EU of the European Parliament and of the Council of June 8, 2011 on

alternative investment fund managers in 2015. In this context, Italian private equity fund managers have been impacted by the following provisions: (i) rules prohibiting "asset stripping" by private equity firms in the case of an acquisition of control over a 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 have required all Italian corporate entities to disclose to the Companies' Register the identity and relevant information on the beneficial owners of the companies. The definition of beneficial owner is coherent with the EU framework and also applies to private equity funds holding interest in Italian corporate entities.

11.2 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 enhanced restrictions applying to private equity investors. It remains understood that, in the case of transfers of equity interests, the status and characteristics of the transferee are relevant in the context of any authorisation procedure, where applicable. 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 or companies subject to the golden power regime.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

Recent key changes to the regulatory regime of Italian AIFMs are mostly driven by EU legislation on sustainable finance.

After the entry into force of Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (the Disclosure Regulation) and Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (the Taxonomy Regulation), many funds are now being structured and promoted as being compliant with Article 8 or 9 of the Disclosure Regulation, also in view of the allocations that several institutional investors have reserved for funds in this category.

11.4 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.

Another factor to be taken into account by private equity players in the Italian market is that the surge of the presence of global investors in the Italian private equity sector also raised the bar on environmental, social and governance ("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 nowadays 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 relevant M&A contractual documentation.

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 due diligence may become a smoother process.

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.

11.5 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 has 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).

11.6 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 nonexistent 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.

12 Other Useful Facts

12.1 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 continuing implementation of the NRRP has represented a significant leverage in the private equity activity. This plan is intended to trigger a transformational economic and social change in Italy, with the aim of resetting the "rules of the game in the Italian society". It is based on three strategic axes: (1) digitalisation and innovation; (2) ecological transition; and (3) social inclusion, with a clear environmental, social and governance (i.e. ESG) focus to promote sustainable development with positive long-term effects on the community and the environment. The NRRP's impact might result in a big incentive for the Italian business environment and M&A industry.

The ongoing implementation of the NRRP coupled with a renewed political stability, which will hopefully permeate the year ahead strengthening the international investors' confidence in the Italian business environment and, at same time, encouraging Italian family-owned businesses to embrace generational handovers and open their businesses to global markets.

Another important driver for the private equity is the necessity for the Italian family-owned businesses to consolidate their business and/or open their capital to: (i) strategic business lines; or (ii) to financial sponsors. This will help for a stronger growth/consolidation, internationalisation, managerialisation, innovation, and generational change.

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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?

Buyout funds using leveraged financing, and start-up deals by venture capital funds (VC), have become synonymous with private equity (PE) in Japan. By value, the Japanese PE market is dominated by buyouts. Japan generated 21 buyouts in 2021.

Between 2014–2020, while PE deals were on average 1.3% of the US's GDP and 1.5% of UK's, they were only 0.2% of Japan's. For VCs, while USD 329 billion was raised by VCs to invest in US start-ups in 2021, Japan only raised USD 5.8 billion. However, PE deals have steadily risen since the early 2000s. 2021 was a record year for PE deals, with a total of 132 deals and total deal value of USD 8.9 billion. In 2022, however, the total deal value for PE in Japan dropped by 28% from 2021, largely due to exchange rate fluctuations caused by a weak yen.

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

Japanese shares are well known for trading below market value, and Japanese public companies' price-to-earnings ratios are significantly cheaper than those of the US.

Inflation has been low for decades and the yen is also weak. Recent corporate governance code reforms put pressure on Japanese companies to restructure operations, leading to a proliferation of conglomerates making divestments and carveouts of their non-core assets. The sale to PE of significant Japanese entities was unthinkable a decade ago.

Attitudes towards PE investors have changed too. PE is the antithesis of stereotypes of how Japanese companies operate, with institutional investors being passive and decision-making being consensus-based. In addition, the COVID-19 pandemic increased the pressure to accelerate change, especially digitalisation. The dynamism, digitalisation expertise, and the global network that PE can bring to Japanese companies have never been more attractive. This is especially true for CEOs over 60 years old – Japan's largest group of business owners, with the average age of a CEO in Japan being 60. Combined with a shrinking population and educated younger generations moving to Tokyo rather than taking over family businesses, this has resulted in increasingly serious and pernicious Japan-wide succession problems. Small to medium-sized businesses (SMEs) account for 99.7% of Japan's 3.8 million companies, and government data shows over 40,000 SMEs are looking for a successor, indicating the succession M&A boom will continue to encourage PE investment.

Geopolitical tension has also meant the "dry powder" raised for Asian deals, now less likely to be used in China, will be used in Japan. Japan is a mature but politically stable economy, making it appealing as an alternative investment.

1.3 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.

While pension funds account for around a quarter of PE investments worldwide and constitute the biggest group of investors, the biggest players in Japan are corporate investors and banks, with pension funds accounting for only 10%.

However, in 2020, the Government Pension Investment Fund (GPIF), the world's biggest pension fund, published a five-year investment plan that outlined its intention to set aside up to 5% of its investments for "alternative investments", including PE. As at the end of March 2022, JPY 3 billion had been invested into PE. In 2022, GPIF executed its first investment agreement with a domestic start-up fund.

2 Structuring Matters

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

There are four main vehicles: investment limited partnerships (LPS) and foreign limited partnerships are the most common, with general partnerships (GP) and silent partnerships (*tokumei*

kumiai) used in limited cases. The best vehicle depends on the nature of the fund's contemplated transactions and other factors, including the number of partners and whether the fund will invest only in Japan.

The typical LPS acquisition structure involves the LPS establishing a special purpose company (SPC) and acquiring common stock in the target company through the SPC.

2.2 What are the main drivers for these acquisition structures?

Tax benefits, limited liability of the limited partners and the ease of setting up are drivers for PE choosing an LPS structure.

An LPS is prohibited from investing 50% or more of its assets in foreign companies unless expressly permitted by the Ministry of Economy, Trade and Industry (METI) Minister. Thus, in cases where the fund contemplates that more than half of its investments will be in foreign companies, a foreign LPS established in tax-neutral countries is common. The pass-through status of a foreign LPS will be further discussed in question 10.4.

On the other hand, in a GP, all partners would be liable for the GP's liabilities, and, in a silent partnership, an investment manager enters into individual agreements with "silent partners", making it difficult to manage if the fund has numerous partners.

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

Buyouts are the most common in Japan for traditional PE investors, with 60% of buyouts using leveraged buyout (LBO) financing for acquisitions in 2021, according to METI. Funds collect investment from institutional investors and prefer to take majority equity. This control allows PE to execute its business model; to restructure and implement dynamic change in an existing business.

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

Like other jurisdictions, securing veto rights to fundamental decisions concerning the direction and operation of the target company in the shareholders agreement (SHA) is crucial. Minority investors may want to negotiate appointing an observer to the board of directors and securing rights to obtain information from the target company since, as a general rule under the Companies Act, resolutions at shareholders meetings for the election or dismissal of officers must be passed by the majority of shareholder votes.

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 given to management varies case-by-case. Ordinarily in buyouts, PE take majority control and only a minority is allocated to management.

Compulsory acquisition provisions often agreed between PE and management equity holders in the SHA include drag-along rights.

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 those who cease to be contracted because of retirement, disability or death, or expiration of the term of office.

Bad leavers are those who have their management contract terminated for a breach of contract or of a duty of care owed to the company.

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 including veto rights are agreed in SHAs or investment agreements that are not publicly disclosed. However, the terms of different classes of shares must be registered on the corporate registry that is publicly available.

For VCs, in most cases, preference shares may be issued, giving VCs a right to appoint a board director, preferential dividend payments, and/or preferential distribution of residual assets, though less common for traditional PE funds.

Alternatively, early VC shareholders may agree to a "deemed preferred stock" scheme. This is the Japanese solution to common issues faced by issuing traditional "convertible notes" that in other jurisdictions are usually used by angel investors in the initial financing round. Deemed preferred stock is created by issuing common stock and all shareholders agreeing to convert it into preferred stock in the next financing. They can be issued through the standard procedure of issuing common stock, eliminate the need to hold meetings required under the Companies Act for preferred stockholders, and have a positive effect on the company's debt-equity ratio.

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 PE holds the majority of stock, veto rights are unnecessary. For VCs (and traditional PE taking a minority position), veto rights are frequently agreed. These are decided on a case-by-case basis, but may include rights over: (i) the constitution of the company, including amendment of governing documents and organisation/reorganisation; (ii) those relating to capital, including share buybacks, stock splits, and new shares; (iii) those relating to the direction of the company such as business plans; and (iv) those relating to day-to-day operations, such as the execution of material contracts, transfer of assets over a certain amount, and taking on debt.

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?

Parties to SHAs are free to come to their own veto arrangements, the contractual law caveat being that they cannot violate public morals.

However, the orthodox legal view is that a breach of SHA veto provisions only allows damages as a remedy and is not a ground to invalidate shareholder resolutions.

However, recent cases discussed the possibility that if the shareholders' intentions are clear in creating a legally binding obligation, and that all shareholders of the company are a party to such SHA, such relief as an interim injunction of exercising of voting rights or invalidation of a shareholder resolution could be granted.

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

There are no legal duties specifically owed by a PE investor 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)?

Although a company established in Japan must comply with the Japanese Companies Act, parties to SHAs are free to choose foreign governing laws and jurisdictions. Parties are also free to include non-compete and non-solicitation provisions in SHAs. As a rule of thumb and in practice, a restriction of two to three years would be deemed as reasonable by the court, and what would be deemed reasonable will depend entirely on the circumstances.

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 Foreign Exchange and Foreign Trade Act (Forex Act) restricts investments by foreign investors in certain sectors, and persons/entities from certain geographic areas. These include investments relating to national security and protected domestic industries such as agriculture. If a foreign investor desires to appoint itself as a director of the target company, that is engaged in these restricted sectors, then the Forex Act requires that a 30-day-prior notification is submitted through the Bank of Japan to the Minister of Finance and the minister having jurisdiction over the relevant transaction (hereafter abbreviated as "Authorities").

Directors also owe a duty of care to the company that may at times conflict with the PE investor's interests. If a director breaches their duty of care to the company they are on the board of, they can be held liable for resulting damages.

In some cases, to mitigate liabilities of directors (especially for outside directors) the articles of association of a company may have a clause allowing to execute a contract limiting the liability of directors on the condition they do not partake in the daily operation of 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 a conflict-of-interest transaction (e.g., when a director intends to carry out transactions that compete with the company, or a director wishes to receive a loan from the company), the Companies Act requires that such director obtain prior approval from the board of directors (if the company has no board, then the shareholders meeting) to conduct the transaction.

The Companies Act further prohibits a director who has a special interest in a resolution, including a director who intends to conduct a conflict-of-interest transaction as mentioned above, from voting in the approval of the resolution, and such a director will be excluded from the quorum.

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?

Merger control regulations may require that buyers make a filing to the Japan Fair Trade Commission if (i) the annual turnover of the acquiring parties and the target meet the relevant thresholds, and (ii) the acquisition of shares by a party results in such party holding more than 20% or 50% of the total voting rights of the target.

Under the Forex Act, if foreign investors either (a) acquire shares of a non-listed companies (except for purchases from foreign investors), or (b) acquire shares of a listed companies whereby the shareholding or voting rights ratio of such foreign investors after the acquisition is at least 1%, foreign investors must submit a 30-day prior notification or file a post-closing report to the Authorities, with some exemptions. The government can block potential investments but, to date, there has been only one case where a suspension order was issued. While the government has an open-door attitude towards foreign investors, the recent regulatory reforms' tightening grip on foreign investments shows a slight shift in its attitude.

In 2021, Chinese tech giant Tencent Holdings acquired a 3.65% stake of Rakuten Group, Inc. The fact that such a politically sensitive transaction was able to close without needing to submit a prior notification shows the potential loopholes in the Forex Act, and highlights differences between rigid FDI regulations of other jurisdictions such as the Committee on Foreign Investment in the United States (CFIUS). While no prior filing was eventually required, a few days before the closing of the transaction Rakuten announced that the closing may be delayed due to procedures required under the Forex Act. Rakuten's sudden announcement served as a cautionary tale. We now see more foreign investors initiating pre-consultations with the Bank of Japan if a notification obligation could possibly be triggered.

Subsequently, in May 2022, the Economic Security Promotion Act – Japan's first comprehensive economic security legislation to enhance national security – was enacted. The act provides four measures: (i) securing resilient supply chain for strategic resources; (ii) securing safety and reliability of key infrastructures; (iii) research and development (R&D) aid for advanced technologies; and (iv) nondisclosure of sensitive patents. As a result, in April 2023, additional sectors were added to the "core business sectors" that require prior notification and review by the Japanese government under the Forex Act, including manufacturing equipment businesses of semiconductors and storage batteries.

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

In general, since the recent arrival of PE in Japan, transactions

terms have been investor friendly. This is because the PE climate in Japan has been heavily influenced by investor-friendly US PE market.

5 Transaction Terms: Public Acquisitions

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

The Financial Instrument and Exchange Act (FIEA) requires any non-open market acquisition that results in investors owning more than ⅓ of all issued stock in a public company to be conducted by a tender offer.

To squeeze out minority shareholders: (i) if PE investors already hold 90% or more of the total voting rights, they can do so by demanding the minority transfer their shares, provided that the prior approval of the board is obtained; and (ii) if not, a special resolution of the shareholders meeting is required to approve the squeeze-out process, such as a consolidation of shares or a share exchange.

Further, the FIEA requires investors acquiring a shareholding of more than 5% of shares in a listed company to file a report to the local financial agency within five business days from the acquisition. If new shares in a public company are issued to PE investors through a third-party allotment, the FIEA requires such a company to publicly disclose certain information concerning such investors.

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

Deal protection clauses are rare but available. Where a conflict of interest exists in the transaction (e.g., a management buyout), METI's Fair M&A Guidelines discourage any clause prohibiting the target company from interacting with other buyers. A break-up fee would be permissible, unless it is excessively high.

The Supreme Court remarked in a case concerning a non-solicitation clause in a MOU between *Sumitomo Trust v UFJ Holdings* that, if there is objectively no possibility of reaching a definitive agreement, there could be no binding non-solicitation obligation. The court stated there was still a possibility of reaching a definitive agreement in this case. Nonetheless, it rejected an interim injunction sought to prevent UFJ from approaching Mitsubishi Tokyo Group, one reason being that damages suffered by Sumitomo Trust were merely a loss of an expectation that the parties would conclude a 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?

Unlike European deals, most Japanese deals adopt the closing account structure. This applies to both buy-side and sell-side, and we rarely see locked box structures used in Japan.

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?

Many of the warranties and representations typically seen in Japanese deals are based on buyer-friendly US-style contracts and have become even more buyer-friendly than typically seen in US-style contracts. For instance, the definition of "material adverse change" is often drafted to be simple and vague, giving the buyer the right to invoke the clause in a range of circumstances. Warranty clauses are more extensive if a foreign company or PE is involved.

Typical warranties in relation to PE sellers include title to shares, capacity, required corporate procedures being met, and satisfaction of necessary government filings. In relation to management, they include warranties in relation to the target company's financial statements, bank borrowings, and compliance with laws.

Unique to Japan, it is standard to include that neither the company nor the management are involved with "anti-social" forces, i.e., no dealings with organised crime groups such as the mafia.

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?

Pre-closing covenants are in line with international standards and include covenants to operate the business in the ordinary course of business, or not to do anything that would materially adversely affect the business, although the definition of "material adverse effect" is rarely as detailed as in US-style contracts.

If specific risks in relation to the target company are uncovered during the due-diligence process, indemnities and special indemnities are commonly included – often with a cap and time limit.

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

Warranty and indemnity (W&I) insurance is a recent phenomenon in Japan. Many Japanese companies do not have experience with W&I insurance, and foreign insurance companies dominate the market. Because calls with underwriters must be conducted in English, and legal due diligence reports must be translated for underwriters, thus creating additional costs, Japanese companies are resistant to involve W&I insurance brokers for domestic deals. It is usually necessitated by a foreign PE.

The excess and policy limit depends on the size of the transaction and the result of due diligence. Tax liabilities, especially secondary tax liabilities, are typically carved out.

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 limitation on PE's liabilities with respect to the amount and the period are typical. If W&I insurance is used for transactions, more aggressive limitations may be set.

The cap on the liability of sellers is much higher than jurisdictions such as the US and is set anywhere between 10% and 40% of the purchase price. The time period is in line with international standards; it may be 10 years from closing for fundamental warranties, but shorter for general warranties that are typically set for one to three years. In any event, Japanese buyers usually secure a period long enough to allow them to create a round of financial statements to assess the financial status of the company.

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 uncommon for PE sellers to provide securities. Escrow accounts are uncommon, as the law prohibits entities other than trust banks, commercial banks, or lawyers from becoming escrow agents.

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 cash transactions, it is common to include a warranty on the solvency of the buyer. Where buyers use debt financing, condition precedents to closing may include the buyer's submission of a copy of a commitment letter issued by a 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?

In general, reverse break fees are not prevalent in Japan but would be enforceable provided that the amount is reasonable.

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?

PE sellers considering an initial public offering (IPO) exit must comply with disclosure requirements set by the Financial Services Agency of Japan (FSA) under FIEA, as well as listing regulations set by each stock exchange – including the Tokyo Stock Exchange (TSE). For instance, TSE rules require companies to have at least one independent officer.

Costs of IPOs include the listing examination fee and initial listing fee; in case of the TSE, JPY 4 million and JPY 15 million respectively. There are many other fees such as to underwriters, auditors, and listing maintenance costs.

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

It is common for underwriters to impose lock-up periods in underwriting agreements.

If PE investors wish to list on the TSE, its rules state that investors who have been allotted shares within a one-year period prior to the IPO must not transfer their shares until the later of (a) six months after the IPO, or (b) one year after such shares were allotted.

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

Dual-track processes are not as common as in other jurisdictions, and potential sellers rarely run an M&A sale track alongside a potential IPO 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 (including the syndicated loan market, private credit market and the high-yield bond market).

For traditional PE funds, regardless of the size or type of transaction, debt financing is typically in the form of a senior facility loan, often by Japan's "megabanks", increasingly combined with mezzanine financing, including subordinated loans, convertible debt, or preferred shares. For larger deals, we see syndicated loans financed from several banks. In general, the value of these loans has been increasing, as seen in recent famous examples such as Japan Industrial Partners' led consortium acquiring Toshiba.

The SPC set up by the PE typically takes out the loan to acquire stocks in the target company. Bonds are rarely used as a source of financing, as the issuance of secured bonds is regulated under the Secured Bond Trust Law.

Due to the lack of assets and trustworthiness in the eyes of institutional lenders, VCs face hurdles in obtaining bank loans, and more extensive reviews are conducted by underwriters, resulting in mezzanine financing being more commonly used.

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 Money Lending Business Act regulates who can offer debt financing and any person intending to engage in money-lending business must meet its requirements and register with the FSA. Requirements include having a certain threshold of net assets and, in each office, having a person who passed examinations conducted by the FSA. This has the practical effect of limiting entities offering debt financing to banks and insurance companies.

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

While equity funds are commonplace, we have also seen the rise of debt funds – both general debt funds and those dedicated to financing start-ups – in acknowledgment of their benefits of being more secure than equity and better returns than traditional bank loans. Recent examples include MUFG's launch of a venture debt fund worth USD400 million, as well as Money-Forward's first independent debt fund dedicated solely to start-ups.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

While secondary transactions have been rising globally, they are less prevalent in Japan. The limited number of secondary transactions in Japan are mostly LP-led. However, the recent launch of funds such as Japan Private Equity Opportunity 2021 – a partnership between Alternative Investment Capital and WM Partners that focuses on investments in the secondary market – shows there is an increasing appetite for transactions in the secondary market.

9.2 Are there any particular legal requirements or restrictions impacting their use?

Japan's Proprietary Trading Systems (PTS) – similar to that of Alternative Trading Systems (ATS) in the US – have been prohibited from trading private company stock. In April 2023, the FSA announced a draft bill that proposes to relax these regulations for transactions where the buyers are certain investors such as banks, brokerage firms and insurance companies, with the view of fostering a domestic secondary market.

10 Tax Matters

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

Foreign investors who have permanent establishment in Japan must file tax returns in Japan, and a fund must withhold tax when making distributions to such foreign investors.

If at least one general partner of the LPS has permanent establishment, other partners, including foreign limited partners, will be deemed to have permanent establishment. However, if a foreign investor (i) is a limited partner, (ii) is not involved in the operations or management of the LPS, (iii) owns an equity interest in the LPS of less than 25%, (iv) does not have any special relationship with the general partner, and (v) does not have any other permanent establishment in Japan, then such investor has no obligation to pay taxes on the income attributed to the permanent establishment of the LPS.

However, foreign investors who sell 5% or more of shares in a Japanese company and own 25% of such company's shares within the previous three years must pay taxes imposed on capital gain from the sale, even if such investor has no permanent establishment in Japan.

10.2 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)?

If PE allocate stock options to management teams, they can elect between a non-qualified stock option plan or a qualified stock option plan: the difference being that, for non-qualified stock option plans, if the stock option is exercised, it will be subject to income tax of up to 55% on the difference between the market price at the time of exercise and the strike price. It will further be subject to a capital gain tax of around 20% on the sale price from the market price at the time of exercise.

If all criteria are met for the qualified stock option plan, there will be no taxation at the time of exercising such right; however, a capital gains tax of around 20% will be imposed on the difference between the strike price and the sale price.

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

Capital gains tax will be imposed when shares are transferred. However, if certain exemptions are met, transactions such as a merger, share exchange or share transfer can be considered a qualified reorganisation and no capital gains tax will be imposed under the Corporation Tax Act.

10.4 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 Supreme Court ruled in 2015 that a Delaware LPS was deemed a corporation for Japanese tax law purposes instead of a tax-transparent entity; however, after the ruling, the National Tax Agency stated that it will no longer challenge the tax-transparency status of a US LLP.

As for tax status of a Cayman LPS, the courts have in the past affirmed that such LPS will be treated as tax-transparent.

11 Legal and Regulatory Matters

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

In line with the international trend towards liberalising regulation concerning SPACs, the FSA's working group is examining the introduction of the "J-SPAC" system in Japan.

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

The Forex Act regulates foreign direct investments from a national security perspective. In general, foreign investors investing in Japan must submit an *ex-post* fact report to the Authorities. For certain investments involving particular types of businesses and geographic areas or countries, however, a prior notification is required.

Additionally, the government recently enacted legislation to regulate the use of land viewed as important for national security, including remote islands and areas near Japan Self-Defence Force bases.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

To tackle concerns around publicly offered trust funds greenwashing and overstating their environmental impact, the FSA amended its guideline to define the scope of an "ESG investment trust". Under the amended guideline, investment trusts cannot use words such as ESG, Impact or Sustainable in their

name unless they are categorised as an "ESG investment trust". Funds that desire to do so must meet certain requirements, such as having ESG as a key factor in the selection of investment assets and complying with disclosure requirements.

11.4 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 entirely depends on the risk appetite of PE investors and the nature and size of the company/transaction.

Traditional PE acquiring stock in established companies may conduct detailed due diligence in line with international standards – on corporate, labour, licences and permits, data privacy, environmental, litigation and compliance issues, and, increasingly, on human rights. Materiality thresholds are assigned based on deal-breaker considerations of the PE, nature of the company, and the size of the deal.

On the other hand, VCs investing in start-ups with no significant assets may opt for a light due diligence.

11.5 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.)?

Bribery and corruption issues are regulated for both domestic and foreign corruption and bribery, respectively under the Criminal Code and the Unfair Competition Prevention Act.

To avoid inheriting bribery issues of target companies, PE should conduct thorough due diligence to ensure compliance with anti-corruption and anti-bribery laws and secure representations regarding the company's compliance. The degree of such due diligence, and extensiveness of representations depends on the level of the company interactions with government officials and the industry and third-party contracts of the company.

11.6 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?

PE investors will not be responsible for the liabilities of its portfolio companies, nor will one portfolio company be liable for another portfolio company's liabilities.

12 Other Useful Facts

12.1 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?

Japan remains an attractive market for PE investors. It is investor-friendly and a stable economy with a sophisticated professional service sector that can assist with PE acquisitions. Recent regulatory reforms concerning start-ups are promising in creating a start-up culture in Japan. In April 2023, as part of the Japanese government initiative to foster FDI and increased M&A activity with foreign investors, METI published its first case study guide of M&A conducted by Japanese companies with foreign investors and foreign private equity. The guide introduces real examples of Japanese companies transacting with foreign investors and private equity, giving advice, practical considerations, and overall encourages Japanese companies to transact with foreign investors. Other than the common roadblocks discussed in the preceding questions, there are currently no further issues that PE investors face when investing in Japan.

Dai Iwasaki has represented numerous local and foreign clients in a broad spectrum of businesses and industries. His scope of experience includes assisting and representing clients in M&A and general corporate matters, antitrust matters (including merger filings and compliance) and high-tech and internet business matters (including privacy and cyber security), as well as international and domestic litigation. He has been recognised as a recommended lawyer of his field by *Global Law Experts*.

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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 South Korea, the most common type of private equity transaction is the Private Equity Fund ("PEF") scheme. The private equity market in South Korea has grown more than five times in size since 2021. Additionally, the number of PEF management companies increased from 35 in 2007 to 394 in 2021, and the number of registered PEFs grew from two in December 2004 to 1,060 as of December 2021. Thus, the PEF market in South Korea is consistently expanding.

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

Recently, improvements in PEF-related regulations in South Korea have resulted in a significant increase in PEF transactions. Originally, the market size of public offering funds was larger in South Korea, but amendments to PEF-related provisions of the Financial Investment Services and Capital Markets Act (the "Capital Markets Act") in October 2015 enabled the market size of PEFs to surpass that of public offering funds starting from 2016. These amendments relaxed previously rigorous regulations on PEFs that were similar to those applied to public offering funds. As a result, the Assets Under Management ("AUM") of PEFs grew approximately four times from KRW 34 trillion at the end of 2015 to KRW 145 trillion in June 2020.

Furthermore, amendments to the Capital Markets Act in 2021 changed the method of classifying PEFs. Originally, the classification was based on operational purposes, but it is now based on profiles of current investors. Through these amendments, the limit on the number of investors in a PEF was expanded from a maximum of 49 investors to a maximum of 100 investors, including 49 general investors, thereby making fundraising more efficient. Additionally, restrictions were lifted for institutional PEFs in which foreign investors equivalent to qualified institutional investors could invest. Specifically, (i) the requirement to acquire voting shares of 10% or more when investing in certain companies was removed, and (ii) investments in institutional PEFs that do not participate in management of target companies became possible. These relaxed regulations allowed investors to expand their scope of investment to direct lending, purchase of loan obligations, investments in minority shares under 10%, and investments in real estate. Now, PEFs operate investments in private credit, including direct lending and mezzanine capital fund.

1.3 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.

Globally, pension funds in each country are generally the largest investors in their respective private equity markets. In South Korea, however, Korean pension funds were unable to invest in the private capital sector through institutional PEFs and were only able to invest for the purpose of management participation until 2021. Accordingly, pension funds invested in the private capital sector mostly through overseas PEFs or domestic hedge funds (i.e., general PEFs other than institutional PEFs).

Amendments in PEF-related provisions of the Capital Markets Act in 2021, however, allowed Korean pension funds to invest in various sectors through institutional PEFs without the need to participate in management of target companies. The amendments created an environment in which pension funds and other institutions can more actively invest in domestic PEFs. In fact, South Korea's National Pension Service ("NPS"), in its management strategy, has expressed its intention to invest in PEFs and other alternative investments in the coming years.

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 adopted for private equity transactions in South Korea is the acquisition of shares (e.g., acquisition of existing shares and/or subscription of new shares), and loans through convertible bonds ("CBs") or bonds with warrants ("BWs"). Typically, PEFs directly make investments on the target company, or establish investment vehicles like Special Purpose Companies ("SPCs") to procure funds and execute investments (buy-outs) on the target company.

2.2 What are the main drivers for these acquisition structures?

The primary driver of PEFs is to achieve high returns on investment by actively participating in management, engaging in structural improvements, and selling the target company after increasing its value.

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

Private equity is composed of Limited Partners ("LPs"), such as institutional investors, and General Partners ("GPs") who are responsible for the investment and management of the fund. LPs hold most of the ownership stakes in PEF, with their respective capital contributions determining their ownership shares. GPs, on the other hand, typically hold less than 5% of the ownership stake. The management fees and carried interest paid to GPs are determined through agreements between LPs and GPs.

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

When a private equity investor is taking a minority position, the investor commonly employs mezzanine investment or share acquisition (common or preferred shares) involving loans through CBs or BWs.

In the case of minority stake investments, private equity investors often execute separate shareholder agreements with existing shareholders or exercise minority shareholder rights, such as a shareholder proposal, to constrain the actions of and exert influence over majority shareholders and/or management.

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. Usually, the residual stake of the existing management is often around 10% but varies depending on the deal.

There are often tag-along, drag-along, and put/call options incorporated in the Shareholders' Agreement or Share Subscription Agreement.

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 ensure a smooth transfer of management rights to prevent any negative impact on the company's business and operation. The continued employment of key members, such as founders, is an example.

On the other hand, bad leavers engage in unfair practices, such as taking over a company through so-called "no-capital M&A" using borrowed funds, then misappropriating or embezzling a large amount of funds procured through the company, or disseminating false information to obtain capital gains from the sale of acquired stocks.

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 portfolio companies often retain a portion of the company's ownership from the existing management, and the existing management continues to oversee the company's operations, while the PEF works to stabilise the company's management and implements changes to its governance structure.

For companies required to submit an annual business reports (e.g., listed companies, and non-listed companies meeting certain size or criteria thresholds), there is an obligation to disclose business reports that include information about the ownership structure. There is no such a reporting requirement for companies falling outside of the aforementioned categories.

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?

Directors appointed by a private equity investor hold equal voting rights as other directors on the board. Furthermore, in a share subscription agreement or shareholders' agreement, it is common to include provisions that require prior consultation or prior consent from the private equity investor regarding key management matters of the company. In such cases, the private equity investor effectively holds veto rights over major corporate actions.

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

The matters are agreed upon between the contracting parties and are not subject to specific restrictions. However, at the shareholder level, the private equity investor can exercise voting rights based on the number of shares at shareholder meetings, and any shareholders' agreements that violate the principle of shareholder equality are not effective. Additionally, at the board level, each director holds one voting right. Therefore, if the company violates provisions in the share subscription agreement or shareholders' agreement requiring prior consent from the investor and passes resolutions in shareholder meetings or board meetings, the effectiveness of those resolutions cannot be challenged. Instead, the company or existing shareholders may be held accountable for breach of contract.

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?

While the details of each deal vary depending on the agreement between parties, it is generally not common for private equity investors to directly impose contractual obligations on minority shareholders. Minority shareholders, particularly management shareholders, usually bear obligations to cooperate with the appointment of investor-designated directors, provide business reports to investors, obtain prior consent from investors, adhere to non-compete agreements, and abide by continuing employment obligations.

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 matters are agreed upon between the contracting parties and are not subject to specific restrictions. The governing law

and jurisdiction can be agreed between the parties. Nonetheless, (i) corporate actions will be subject to the commercial code of the country in which the company is incorporated, and (ii) the Supreme Court held that non-compete and non-solicitation provisions that unreasonably limit competition or excessively restrict constitutionally protected freedom of occupation and right to work are invalid.

Typically, courts evaluate the validity of non-compete and non-solicitation provisions based the nature of the industry, independent economic value of the protected trade secrets, circumstances of the other party's resignation, scope of the non-compete provision (duration, geographic area, and specific job roles), and the amount of compensation. Recently, the trend was to limit the duration to around six months to one year.

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?

Directors appointed by private equity investors are often appointed as "non-executive directors" who do not work at the company on a regular basis. There are generally no special restrictions on qualifications of non-executive directors or ordinary directors. However, when appointing external directors, there are qualification restrictions based on the Commercial Act.

It is important to note that non-executive directors may bear responsibilities towards the company or third parties as registered directors in accordance with the Commercial Act. For instance, directors can be held jointly liable with the company for damages if they intentionally or negligently violate laws or articles of incorporation, or breach obligations. Directors who voted in favour of such resolutions can also be held liable. Therefore, it is common for share subscription or shareholder's agreements to include indemnification clauses for directors appointed by private equity investors.

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

Private equity investors commonly possess the authority to appoint directors and to remove or replace directors. This allows private equity investors to replace or dismiss the directors they have nominated at any time, should a conflict of interest arise.

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 South Korea, with respect to M&A transactions, issues primarily arise in business combination reports under the Monopoly Regulation and Fair Trade Act (the "Fair Trade Act"), capital transaction reports under the Foreign Exchange Transactions Act, and foreign investment reports under the Foreign Investment Promotion Act. Additionally, there may be separate approval requirements based on the industry of the target company, such as qualification reviews of major shareholders under the Act on Corporate Governance of Financial Companies.

Under the Fair Trade Act, if a company with assets or annual sales exceeding KRW 300 billion acquires ownership of 20% (or 15% in the case of a listed company) or more of the total issued shares of another company with assets or annual sales exceeding KRW 30 billion, a corporate combination report must be submitted to the Fair Trade Commission within 30 days from the date of such acquisition, with certain acquisition subject to prior reporting. However, when a venture investment association, which is a type of PEF, acquires shares of a venture company, the reporting obligation is exempted.

According to the Foreign Investment Promotion Act, when a non-resident foreigner invests more than KRW 100 million and acquires 10% or more of the shares of a domestic corporation, or otherwise meets other criteria stipulated in the Foreign Investment Promotion Act, a foreign investment report must be submitted. When a non-resident foreigner is not subject to foreign investment reporting under the Foreign Investment Promotion Act, the non-resident foreigner must submit a capital transaction report under the Foreign Exchange Transactions Act and Foreign Exchange Transaction Regulations stipulated by the Ministry of Economy and Finance.

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

According to the Financial Services Commission's announcement in May 2023, global and Korean M&A markets in 2022 were affected by rising interest rates and global economic slowdown. In response, the Korean government expressed its intent to introduce corporate M&A policies to actively promote the economy and innovations in companies. These measures include alleviating the burden of securing funds in advance of tender offers.

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?

If a PEF possess more than 5% of voting shares in a listed company, it is required to report the ownership status and purpose of the ownership to the Financial Services Commission and the Korea Exchange ("KRX") in accordance with the Capital Markets Act. Additionally, if there is a change of 1% or more in the ownership percentage or if there are significant changes to the reported information, such changes must be reported. The applicable regulatory requirements differ based on whether the ownership of the shares is intended to influence the management of the portfolio company. Simplified regulations apply when there are no such intents.

Furthermore, the Capital Markets Act stipulates that if an individual intends to acquire shares or certain securities from 10 or more individuals outside the exchange within a six-month period, and the resulting combined ownership of the individual and his or her related parties is to exceed 5% of the total issued shares, the individual is required to purchase the shares or securities by tender offer.

In December 2022, the Financial Services Commission pointed out that the existing tender offer regulations lacked

protection for general investors of target companies because they did not adequately ensure opportunities for the general shareholders to sell their shares. As a result, the Financial Services Commission expressed its intention to introduce a mandatory public tender offer scheme. However, in May 2023, the Financial Services Commission announced that it would take a more balanced approach in adjusting the proposed mandatory public tender offer scheme.

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

A public tender offer is carried out by securities companies (tender offer agent) as intermediaries, so there is not much concern about deal protection. However, during the tender offer period, shareholders can revoke their acceptance at any time, and private equity firms cannot claim damages or penalties for such revocation.

On the other hand, a typical M&A transaction in South Korea does have deal protection mechanisms such as liquidated damages, penalty clauses, and exclusivity provisions.

6 Transaction Terms: Private Acquisitions

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

In South Korea, there are many M&A transactions that do not include purchase price adjustment clauses. However, when there are purchase price adjustment clauses, completion accounts, locked box and earned-outs are commonly used.

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?

Representation and warranty clauses in South Korea are largely adopted from commonly used representation and warranty clauses in the UK and the U.S., and often include buyer-friendly provisions. Generally, representations and warranties of minority shareholders typically include clauses regarding the legal, valid and complete ownership of shares, and the proper authority to sell (although specifics may vary case by case). However, details related to the management of the target company are usually not included or are included in a limited way.

On the other hand, representations and warranties of largest shareholder or shareholders with influence on the management of the target company typically include clauses regarding non-existence of causes of share dilution, non-existence of shareholders' agreement, integrity of financial statement, attainment of government approvals and compliance with laws, in addition to the clauses included in those of minority shareholders.

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?

Covenant clauses in South Korea are generally adopted from common covenant clauses from the UK and the U.S. Closing covenants typically include clauses regarding ordinary business activities under the normal course of business, compliance with laws, and prohibition of actions that could have material adverse effects. Additionally, there may be covenant clauses that require the target company to obtain buyer's prior consent before engaging in specific actions (such as issuing new shares/bonds or making capital expenditures) prior to 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?

Warranty and Indemnity ("W&I") insurance was introduced in South Korea around 2016 and is utilised in large-scale M&A transactions.

(i) The limit of liability is determined through negotiation between the insurer and the buyer, taking into consideration the transaction size, potential for breach of representations and warranties, and level of insurance premiums (typically around 10% to 20% of the transaction amount).

(ii) Typical W&I insurance excludes risks that the buyer is already aware of, environmental contamination, product liability, underfunded pension obligations, evaluations or estimation about the future, transfer price in related-party transactions, and tax issues relating to rejection of unfair act and calculation.

Insurance premiums are usually set within the range of 1.5% to the upper 3% of the limit of liability, as determined by individual negotiations.

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 South Korea, the liability of sellers in M&A transactions is often limited by capping the amount of damages or setting a time limit for liability, as negotiated between the seller and the buyer.

Various methods are used in capping the amount of damages. These include setting a minimum threshold for individual losses (e.g., claims for damages exceeding KRW 100 million are eligible), requiring the total aggregate amount of claims to exceed a certain threshold (e.g., only claims exceeding a total sum of KRW 1 billion are eligible), or establishing a maximum limit for the total amount of liability (e.g., the liability cap at 20% of the transaction value).

It is commonly set one to three years from the closing date as timeframe for damages.

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 M&A transactions in South Korea, it is not common to require security deposits or similar measures to secure liabilities arising from the breach of representations and warranties.

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

If the acquirer secures funds for the acquisition through debt financing, private equity buyers may be required to provide the

seller with a comfort letter from a financial institution to verify their ability to pay the purchase price as a pre-closing covenant. This is done to ensure that buyers have the necessary funds for the transaction. However, in equity finance transactions, it is not common to provide comfort letter.

If the buyer fails to secure the necessary funds for the acquisition, the contract is typically terminated. In such cases, the buyer may be required to pay a certain amount as a penalty for the breach of contract.

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

In South Korea, there are cases in which a certain amount of the earnest money is structured as reverse break fees, which are paid if the transaction is not completed.

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 South Korea, the primary stock markets are the KOSPI, on which major companies are predominantly listed, and the KOSDAQ, on which technology and growth-oriented companies are predominantly listed. To be listed on these markets, companies need to undergo the listing review procedure of the KRX. The specific listing criteria vary between these markets, but companies must pass formal evaluation criteria (e.g., share distribution, management performance) and qualitative evaluation criteria (e.g., transparency in management, stability in management, corporate governance). Assuming that all listing conditions are met, it generally takes around a year to a year-and-a-half to list a company from start to finish.

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

If the seller is the largest shareholder of a newly listed corporation, the seller is required to hold the shares for one year from the listing date in the KOSPI and six months from the listing date in the KOSDAQ. Additionally, if the seller acquires shares from the largest shareholder or its related parties prior to the listing, both the KOSPI and KOSDAQ require a holding period of six months from the listing date.

If new shares are allotted by a third-party allotment paid-in capital increase before listing, the holding period is as follows:

- KOSPI: either one year from the issuance date or six months from the listing date, whichever comes later.
- KOSDAQ: a holding period of six months from 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?

In South Korea, it is very rare to conduct a sale and an IPO simultaneously. Since the stability of management is evaluation criteria for the listing review procedure, simultaneously conducting a sale with transfer of control and an IPO is highly unlikely to happen in practice.

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 (including the syndicated loan market, private credit market and the high-yield bond market).

The most common source of debt financing used to raise funds for private equity transactions in South Korea is a bank loan, which is usually low-risk, low-interest, and senior-ranking. Apart from banks, various financial institutions such as PEFs, securities companies, savings banks, credit companies, insurance companies, pension funds, and mutual aid associations also participate as lenders. Another method of raising funds is to issue bonds, including CBs and BWs. It is also common to finance in combination with mezzanine financing with higher-risk, high-interest subordinated loans. If the loan amount is substantial, syndicated loans are often used to spread the risk among financial institutions. When conducting M&A, an SPC is usually incorporated to acquire the target company's shares, and the SPC procures funds from lending institutions. On the other hand, high-yield bonds are not commonly used for raising funds in 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?

If an SPC that has procured a loan from lending institutions holds total assets of KRW 500 billion, the SPC would fall under the category of a holding company according to the Fair Trade Act. As a result, the SPC would be subject to debt-to-equity ratio regulation under the Fair Trade Act. However, the Capital Markets Act allows for structural subordination (layered SPC), which can be used to comply with the debt-to-equity ratio regulation imposed by the Fair Trade Act.

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

Due to recent uncertainties stemming from higher interest rates, the debt financing market for private equity has been experiencing a slowdown. Over the past five years, securities companies aggressively entered the corporate lending market for acquisition financing and surpassed the market share of banks. However, with recent rate hikes, increased cost of funding and crisis in the Korean real estate project financing market, securities companies had to limit their aggressive business strategies. As a result, their market share in the debt financing market has recently decreased.

On the other hand, banks, which are considered to be more financially flexible and stable, have noticeably increased their share in the debt financing market compared to that of the previous year. In Q1 of 2023, the share of banks has risen by 15% compared to that of Q1 of 2022.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

Amid an economic downturn, GP-led secondary transactions are increasingly gaining traction in South Korea. Given the

heightened volatility, secondary deals are becoming attractive options compared to new investments. This is because secondary deals tend to have easier valuation and exit negotiations, and provide assurance of stable return on investment. From the perspective of fund investors, there is also a growing incentive to secure liquidity through secondary deals.

Though continuation funds are not prevalent in South Korea, there have been recent cases of continuation funds, and various PEF management firms are showing interest in operating continuation funds. Continuation funds are therefore likely to be used more often in the future. The rationale behind this is that, rather than immediately collecting or realising assets at a low price, renewing the maturity of a fund through a continuation fund can maximise asset value. In other words, it is difficult to value assets at a high price during the period of economic downturn. Therefore, using continuation funds to extend the investment horizon becomes an appealing strategy.

9.2 Are there any particular legal requirements or restrictions impacting their use?

GP-led secondary transactions and continuation funds are generally subject to the same regulations as those governing conventional funds, such as the Capital Markets Act, and there are no specific requirements or restrictions imposed by regulations for these practices.

10 Tax Matters

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

Please note that if an offshore fund is deemed to have a fixed place of business within South Korea, the offshore fund can be subject to taxation in South Korea based on the applicable tax rates specified by the South Korean tax code.

The Supreme Court of South Korea has held that when a foreign corporation carries out substantial and essential business activities through its employees or individuals directed by the employees in a fixed location in South Korea that it has the right to use or dispose of, such as buildings, facilities or equipment, the foreign corporation is deemed to have a fixed place of business in South Korea.

For PEFs, a key factor in this regard is determining whether the significant decisions related to fundraising, investment and investment retrieval have been made within South Korea. If the aforementioned significant decisions are deemed to have been made within South Korea, the offshore fund, despite its foreign profile, can still be subject to taxation in accordance with South Korean tax code.

10.2 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 South Korea, there are no major tax-saving measures specifically for executive compensation. It is common to provide incentives to executives through stock options. When stock options are exercised, the capital gain (the difference between the market price at the time of exercise and the exercise price) is subject to taxation as either earned income or other income.

Additionally, for employees of venture companies, the Act on Special Measures for the Promotion of Venture Businesses provides certain benefits related to stock options granted by venture companies. According to this law, (1) gains obtained from exercising stock options granted by venture companies are not subject to taxation if they are within KRW 200 million, (2) tax payments on gains obtained from stock options can be paid in instalments over five years, and (3) there is an option to defer the taxation point from the time of exercising the stock options to the time of transfer of the stocks.

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

For mergers and divisions, tax-exemption or tax reduction benefits may be provided if the requirements for special tax treatment are met. The requirements include a period of continuity of business operation, perpetuity of ownership interest, continuity of business, and employee retention. Therefore, it is important to review whether such requirements are met.

For the transfer of a business unit, there are no tax deferral benefits in principle. However, when the consideration of business unit transfer is received in stock rather than in cash and certain other conditions are met, tax deferral and tax reduction benefits are granted as the transfer is regarded as a qualified investment in kind.

10.4 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?

Starting from January 1, 2023, the Enforcement Decree of the Act on Restriction on Special Cases Concerning Taxation requires domestic PEFs to clearly distinguish and state the source of income (e.g., dividends, interest, capital gains) when returning profits to foreign investors (e.g., LPs).

In the past, profits returned to foreign investors from domestic PEFs were considered entirely as dividends, which are subject to dividend income tax of up to 20%. If the dividend income tax rate of the foreign investor's country of residence was lower than 20%, the Korean tax authorities withheld tax at such lower rate.

11 Legal and Regulatory Matters

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

Until 2021, the Capital Market Act classified PEFs into "professional investment type" (hedge funds) and "management participation type" (PEFs) based on their purpose of investment. Different asset management regulations were applied based on PEF's investment purposes.

However, with the amendment of the Capital Market Act in October 2021, the requirement to purchase 10% or more of target company's ownership interest with the purpose of participation in management (10% rule) was abolished, and regulations restricting the type of investment were lifted. As a result, PEFs no longer need to have the purpose of management participation when investing but can pursue creative and self-driven

types of investment, such as minority stake acquisitions, loans, structured bonds, and real estate. The change is expected to contribute to enhancement of corporate governance and business efficiency among domestic companies.

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

The Foreign Investment Promotion Act restricts foreign investment when it poses a threat to the national security and public order (Foreign Investment Promotion Act §4, Enforcement Decree of Foreign Investment Promotion Act §5). Specifically, foreign investment that acquires management control over an established domestic company through purchase of shares or other assets is subject to review by the foreign investment committee upon the request of relevant minister or head of intelligence agency if there are concerns related to:

1. hindrance to the production of defence industry materials;
2. items or technologies subject to export permits or approvals under the Foreign Trade Act that may likely to be used for military purposes;
3. risk of disclosing classified state secrets such as contracts;
4. hindrance to international efforts of the United Nations, etc. to maintain international peace and security; and
5. risk of leakage of critical national technology;

Moreover, there is pending legislation (Act on Prevention and Protection of Leakage of Industrial Technologies) that requires domestically established PEFs effectively controlled by a foreign individual to undergo government review and obtain approval from the Minister of Trade, Industry, and Energy when acquiring or merging with companies that possess critical national technologies.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

We did not find any additional legal or regulatory requirements that apply to impact investments.

11.4 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 extent of legal due diligence varies depending on the risk appetite of PEF investors, the size of the transaction, and the nature and complexity of the target company. Legal due diligence is typically conducted by external law firms and generally takes around one to two months.

Generally, legal due diligence is conducted on matters related to general corporate affairs, human resource and labour, permits and licences, contracts, data protection, and legal compliance.

11.5 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 laws is a prerequisite not only for PEF investments and/or transactions, but also for most investments and transactions in South Korea. When engaging in PEF investments and transactions, legal due diligence is conducted to ascertain whether there are any violations on relevant laws, including anti-bribery and anti-corruption laws, and to secure a representation that there are no such violations. The extent of the legal due diligence and the scope of representation vary depending on each case (e.g., bargaining power of the contracting parties, business risks, etc.).

While the Foreign Corrupt Practices Act ("FCPA") is a U.S. law, U.S. PEF investors often perform detailed legal due diligence to determine whether a Korean target company is compliant with the FCPA or requires representation that it is in compliance with the FCPA.

11.6 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, PEF investors are not liable for the PEF's debt beyond the purchase price of the PEF ownership interest already paid. Similarly, PEF investors are not responsible for the debts of portfolio companies. Additionally, portfolio companies are generally not liable for the debts of other portfolio companies.

12 Other Useful Facts

12.1 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?

South Korea is an attractive market for PE investors. Particularly, when compared to neighbouring countries, there are lots of transactions of management shares, and PEFs are taking the leading role such transactions. Additionally, the considerable size of the economy (ranked around the top 10 globally), ongoing improvements in PE-related regulations, and the strong competitiveness of sectors like semiconductors make South Korea an attractive destination for investment.

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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", non-regulated *Société de Participations Financiéres* (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 *sociétés d'investissement en capital à risque* (SICAR, regulated investment companies in risk capital) in 2004; the specialised investment fund (SIF, a regulated alternative investment fund (AIF) vehicle used for any type of investment, including private equity) in 2007; or the reserved alternative investment fund ((RAIF), not subject to supervision by the Luxembourg financial supervisory authority (Commission de Surveillance du Secteur Financier (CSSF)), but to be managed by an authorised external alternative investment fund manager (AIFM) within the meaning of the Alternative Investment Fund Managers Directive). 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 Luxembourg limited partnerships (S.C.S.) and now well-established Luxembourg special limited partnerships (S.C.Sp.) types of limited partnerships (LPs); 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. Both types of legal form have known a significant success and now have become a popular part of the "Luxembourg Toolbox".

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.

1.3 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 private equity 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 recent crises such as the COVID-19 pandemic and the Ukraine war, 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" types of co-investment constellations.

2.2 What are the main drivers for these acquisition structures?

The main motivators are tax efficiency and considerations linked to the investors in the transaction (sole investor or co-investment by two or more sponsors) and the financing of the transaction. International banks providing leveraged finance are familiar with the typical Luxembourg acquisition structures and very comfortably accept security over these structures as collateral.

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

Under Luxembourg law, equity in the strict sense of the term can be structured as issued share capital, founder shares or contribution into the capital reserves. Shareholder loans or hybrid instruments such as preferred equity certificates are another common means for private equity sponsors of providing equity. Management participations and carried interests are commonly structured in separate LP structures specifically put in place for that purpose.

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, comprehensive and regular provision of information, 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 matter.

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 towards 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 from a company law perspective. 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, but the nominee director should be aware of potential conflicts of interest, and agree with the nominating shareholder in advance on procedures or mechanisms, should such conflicts of interest arise during the nominee director's mandate. 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 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, Luxembourg Parliament on 13 June 2023 voted the law implementing Regulation (EU) 2019/452, establishing a foreign direct investment control regime in Luxembourg. Under the new framework, the Ministry of Economy will be able to scrutinise and evaluate proposed foreign investment (i.e. by a natural person or an undertaking of a country outside the European Economic Area) in order to determine whether a foreign investment is likely to affect public security and public order or essential national or European interests. The Ministry of Economy 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.

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.

The law will enter into force on 1 September 2023. While some aspects are still unclear, 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, including the ability of the authorities to impose coercive measures and administrative fines up to EUR 5.

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.

Recent developments on the global stage, such as the COVID-19 pandemic, the war in Ukraine and sanctions imposed by the West in response are now reflected in proposed material adverse change (MAC) clauses and price adjustment clauses.

Like in many other places in the world, ESG matters are now of paramount concern for private equity investors in Luxembourg and are also reflected as a standard in transaction documentation.

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 more frequently than in the past as a means of bridging high seller side valuation expectations and the uncertainties in the current environment.

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 "locked 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?

Initial public offering (IPO) exits are not frequently seen in Luxembourg due to the small stock exchange and as there are very few 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. IPOs at foreign stock markets, including by listing of instruments such as American Depositary Shares, are observed occasionally.

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

A standard is not easily identifiable due to the small number of IPO transactions in the country, but from what could be observed in the recent past, a lock-up period of up to 180 days would appear 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 (including the syndicated loan market, private credit market and the high-yield bond market).

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 (2005 Law), 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. On 15 July 2022, a new law was adopted, which aims to add flexibility to contractual arrangements and includes an overhaul of the system of public auction of the pledged assets.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

The use of continuation fund vehicles or GP-led secondary transactions is an alternative that is at considered relatively frequently by some of the leading private equity houses in Luxembourg when a private equity fund reaches its culmination point. Given Luxembourg's globally market-leading position as a funds jurisdiction generally, it is little surprising that the country is also an attractive location for initiators of secondary funds and continuation vehicles.

9.2 Are there any particular legal requirements or restrictions impacting their use?

The framework and legal requirements largely depend on the intentions and structuring priorities of the fund initiator. In principle, all Luxembourg vehicles, from the special limited partnerships and RAIFs, to SIFs and SICAR, are available, each coming with its specific well-established and tested legal and regulatory framework.

10 Tax Matters

10.1 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 and with a number of other countries (including almost all OECD Member States).

Joint-stock companies are subject to normal corporate taxation (corporate income tax and municipal business tax) on their worldwide income 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 joint-stock companies, allowing for the exemption of certain types of income and exit tax charges for private equity investment.

SICARs (other than LPs) are subject to normal corporate taxation (corporate income tax and municipal business tax), but income derived from transferable securities held by a SICAR does not constitute taxable income. Capital gains realised by non-resident shareholders in relation to the disposal of the interest held in SICARs are not subject to tax in Luxembourg. Dividend distributions made by SICAR are exempt from withholding tax.

LPs (under the legal form of an S.C.S. or an S.C.Sp.) are tax-transparent and not subject to corporate income tax, save for when the reverse hybrid rules introduced by anti-tax avoidance directive 2017/952 (ATAD 2) are applicable. As a general rule, LPs should not be subject to Luxembourg municipal business tax, provided that the LP does not carry out a commercial activity in Luxembourg and provided that the LP's general partner holds, at all time, less than 5% interest in the LP.

SIFs, irrespective of the legal form, are not subject to corporate income tax and municipal business tax on capital gain or income in Luxembourg. Distributions made by the SIFs are not subject to withholding tax. The normal tax due is a subscription tax of 0.01% based on the quarterly net asset value of the SIF. In addition, SIFs owning real estate assets located in Luxembourg, either directly or indirectly through tax-transparent entities, are subject to a 20% real estate levy on (i) gross rental income arising from the real estate asset located in Luxembourg, (ii) capital gain resulting from the alienation of the real estate asset located in Luxembourg, and (iii) capital gains resulting from the alienation of interests in tax-transparent entities holding the real estate asset located in Luxembourg.

RAIFs are subject to the same tax regime as SIFs but can opt for the SICAR regime if the constitutive documents of the RAIF state that its sole objective is to invest in securities representing risk capital.

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

Management teams may have income derived from carried interest that can be structured with units, shares or securities issued by an opaque alternative investment fund. Such carried interest can be conceived in a tax-neutral manner in Luxembourg.

Management teams also considered Luxembourg tax-transparent and tax-neutral partnerships in order to structure their carried interests.

10.3 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, in principle, only taxable in Luxembourg if the capital gains are realised upon the disposal of a substantial participation (roughly speaking, more than 10% over the five years prior to the date of the disposal) within six months from the acquisition of the shareholding.

Generally speaking, Luxembourg has concluded bilateral tax treaties with certain countries stipulating that capital gains realised on shares issued by a Luxembourg company are only taxable in the jurisdiction of the alienator (i.e. except for a real estate-rich company). In this respect, managers resident in such jurisdictions should not be subject to any Luxembourg income taxation for the capital gains realised on shares issued by a Luxembourg company.

In addition, Luxembourg resident managers may benefit from tax relief or tax exemptions on the capital gains realised on shares issued by a Luxembourg company.

10.4 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 from 2022, the reverse hybrid rules introduced by anti-tax avoidance directive 2017/952 (ATAD 2) are applicable in

Luxembourg. According to these new rules, under certain conditions, the Partnership could be considered a resident corporate taxpayer and taxed on its income to the extent that this income is not otherwise taxed under Luxembourg law or the laws of any other jurisdiction.

On 22 December 2021, the European Commission made available a proposed Directive, which sets out minimum substance requirements for companies within the EU, with the goal of preventing such undertakings from being used for tax evasion and avoidance (ATAD 3). It remains to be seen if this proposal will be adopted and how the final text of the directive will look like.

11 Legal and Regulatory Matters

11.1 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. That said, there are some significant developments in the recent past worth being reported: we have already heard about the new foreign direct investment regime (see question 4.1 above). Another potentially significant development in Luxembourg is to be expected with respect to merger control procedures. Currently, Luxembourg is the only EU Member State without a merger control regime in place on a national level, with only the EU Merger Control Regulation (EUMR) providing a framework for prior merger control above for concentrations above the relevant thresholds. Luxembourg now seems to take steps to join other EU Member States in taking a more active role in merger control proceedings and in establishing a merger control regime on national level, too: on 30 January 2023, the Luxembourg Competition Authority joined for the first time an Article 22 EUMR referral request by other Member State competition authorities related to a proposed merger, which falls below EU and Member State notification thresholds, but which raised concerns due to the transaction affecting a certain niche market. On the legislation side, a proposed bill of law is expected to be introduced to Parliament by the Government in July 2023. Observers expect that the bill will introduce a mandatory prior notification regime in line with the legislation of many of Luxembourg's neighbouring countries.

11.2 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. See, however, question 4.1 above with respect to the new regime on foreign direct investments generally.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

Sustainable finance is certainly one of the megatrends of recent years and Luxembourg as the preeminent funds jurisdiction in Europe is playing a central role in shaping this market in the future. In terms of legal framework, since March 2021, investment funds and asset managers have had to comply with the Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (SFDR). Under SFDR, all investment funds are required, *inter alia*, to describe in their prospectuses how sustainability risks are integrated into the fund's investment decisions. Further, asset managers and fund promoters wishing to offer investment products with a core focus on sustainability have two options to have their products classified with different reporting requirements, i.e. as an investment fund, which promotes environmental and/or social characteristics (Art. 8 SFDR), or as an investment fund with a focus on sustainability (Art. 9 SFDR).

11.4 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.

11.5 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.)?

Bribery is not considered to be of major concern when it comes to private equity transactions in Luxembourg. On the 2022 Corruption Perceptions Index issued by Transparency International, Luxembourg scored 77 on a scale from 0 ("highly corrupt") to 100 ("very clean") and Luxembourg ranked 10th among the 180 countries in the index. Luxembourg has strong anti-bribery legislation in place, e.g. the Luxembourg Criminal Code has been amended already in 2011 to implement some of the OECD and European Council recommendations against bribery issued at that time. Luxembourg is also party to two United Nations conventions against bribery and transnational organised crime. 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. In terms of enforcement, the public prosecutor as well as the CSSF, the Luxembourg regulator for the financial sector, are typically intervening in situations where bribery can be an issue. The CSSF has the authority to conduct its own investigations and to issue administrative orders and administrative fines as a sanction for breaches of the anti-bribery legislation. On a contractual level, typically compliance

with anti-bribery legislation is part of the usual set of W&Is in any acquisition or investment documentation.

11.6 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 the 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.

12 Other Useful Facts

12.1 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 long since 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.

Holger Holle is a partner in our Corporate Group. He divides his time between our Luxembourg office, where he leads the corporate practice, and our Munich office. Holger focuses on corporate and finance law and particularly specialises in national and cross-border M&A and private equity transactions. His clients include major banks, international private equity houses and large corporates. His sector focus is TMT and diversified industrials transactions.

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Before joining Eversheds Sutherland, Rafael was a tax partner in an international law firm. He also gained experience in the tax departments of a leading Benelux law firm and of an international accounting firm. Rafael has been recognised as a New Generation Partner in *The Legal 500* EMEA 2022 guide.

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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 72 offices in 35 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.

Eversheds Sutherland's global private equity practices have extensive experience advising on all areas of specialist private equity transactions and across every major jurisdiction. In addition to longstanding relationships with many providers of private equity on both national and international levels, we also regularly advise management teams, corporate and individual vendors and providers of debt finance on private equity 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?

At a fund formation level, managers typically structure the funds either through a publicly traded vehicle (in the form of a trust) or a private corporation serving as the investment vehicle. It is also common for managers to choose foreign jurisdictions to form the fund prior to a local investment. At a transaction level, private equity funds are actively participating in both equity and loan financing structures.

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

One of the most significant factors encouraging private equity transactions in Mexico is the continuous investment by pension funds in the private equity market, through the acquisition of securities issued by publicly traded trusts that serve as private equity funds. Traditional private equity firms have the option of structuring a local fund that will receive investment from local institutional and qualified investors (which include pension funds). In order for such pension funds to allocate resources to publicly traded private equity vehicles, such investment vehicles must comply with strict structural requirements (including a specific investment period, rules for a distribution of dividends/interest, allocation of the investments in local assets, etc).

1.3 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 recent years, there has been more active participation from family offices and asset manager firms structuring transactions in a manner consistent to that of 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?

As a general rule, equity investments in Mexican assets are typically structured as either (i) investing through a local corporation, or (ii) investing through a trust, which could provide tax-transparency benefits to investors (if certain tax requirements are met). The investment is typically made at a holding company level. For local companies, it is common for the holding to also serve as an operating company.

Although private equity vehicles may invest directly in the holding company, it is common for such firms to set up special purpose vehicles ("SPVs") intended to perfect the investment. This is common for foreign firms (which would prefer having a wholly owned local subsidiary that would in turn perfect the investment), as well as publicly traded trust funds like *Certificados de Capital de Desarrollo* ("CKDs") and investment project trust certificates ("CERPIS"). The use of an SPV is directly linked to the tax structure of the fund and the investment.

2.2 What are the main drivers for these acquisition structures?

An investment structured through a corporation typically uses the form of a *Sociedad Anónima Promotora de Inversión de Capital Variable* ("SAPI"). The SAPI is a flexible corporate governance structure that offers alternatives for investors to assume a controlling participation holding a minority stake in the company.

Mexican income tax legislation allows certain types of trusts to act as transparent vehicles for its investors. In order for investors to claim such benefits, both the trust and the investment would need to comply with certain structural rules. Investments in real estate assets are commonly structured through a trust.

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

In terms of the investments, the corporate flexibility that a Mexican SAPI offers, allows for multiple investment structures. With a SAPI, the company may issue several series of shares, allocating different characteristics to each one.

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

The threshold for statutory minority rights in an SAPI are the lowest available for any type of business corporation in Mexico, starting at 10% of the float. In addition to such statutory rights, minority investors are able to add additional rights to their stake. These minority rights are documented in the by-laws and in standalone shareholders' agreements entered into by all shareholders. It is common for minority shareholders to negotiate certain rights (such as a preferred distribution, appointment of directors and officers, veto rights for certain corporate matters, 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?

Equity allocated to management varies considerably from deal to deal. Large local corporations in Mexico are usually family owned and historically managed by members of the family. In recent years, a trend for external professionals assuming management duties has been seen, but most of these companies would maintain some family members as officers or directors.

Please note that labour laws in Mexico are very protective of employees. Such laws could have an impact in equity structures offered to managers in Mexico. A case-by-case review is recommended for every management equity arrangement.

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

As mentioned above, labour relationships are highly regulated in Mexico. The terms of employment (including those of management) shall provide minimum statutory benefits and will be subject to legal protections for termination process and severance payments. Under such rules, generally, an employee will have limited scenarios that would give the right to terminate the employment.

As a result of such legal provisions, labour courts and precedents could have an impact in any valuation changes that are applied due to leaver clauses.

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?

Corporate by-laws and/or shareholders'/partners' agreements would normally include special rights for private equity investors (in the form of minority rights), which typically include, among others: (1) preferred stock and dividends; (2) board appointment rights; (3) voting/veto rights in respect of specified matters (see question 3.2 below); (4) rights of first refusal in respect of equity transfers or increases; and (5) drag-along and tag-along rights. Corporate by-laws for Mexican entities are registered before the Public Commerce Registry for the relevant entity's corporate domicile – these registries are publicly available. Other agreements are private.

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 the case of an equity transaction and depending on whether the acquisition is for a minority or majority stake, sponsors usually seek presence on the board, veto powers over certain supermajority matters at the shareholder and board levels (e.g., mergers, disposal of assets, indebtedness, change of business line, etc.), as well as other protections regarding their exit from the investment, ranging from tag-along and drag-along rights, as well as preferential rights in a potential initial public offering ("IPO"). The foregoing is either documented in a shareholders' or subscription agreement or is reflected in the by-laws of the acquired company.

Regarding debt transactions, investors and lenders are also likely to request board presence and will want to have a say over certain corporate and business matters – this is typically structured through representations and warranties and affirmative and negative covenants in the loan agreement. Likewise, if the deal involves a syndicate of lenders, the relationship between the members of the syndicate and their rights with respect to the debt will likely be set forth in an intercreditor 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?

As explained, so long as such veto arrangements are duly documented in the entity's corporate by-laws, no limitations of the effectiveness of these would apply.

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?

Mexican law does not provide for such duties. Nonetheless, these duties may be agreed upon via the entity's corporate by-laws and/or shareholders'/partners' agreements (i.e., contractual duties rather than statutory duties).

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

Generally speaking, Mexican law allows for broad contractual freedom (except when agreements conflict with law or social measures). Moreover, Mexican corporate law expressly prohibits contractual arrangements that contradict the minimum rights afforded to minority shareholders/partners by law. Having said this, provisions included in entities' corporate by-laws will always prevail over contractual arrangements – in any case, care should be taken as to avoid contradictions between by-laws and contractual arrangements.

As such, governing law/jurisdiction and non-compete/non-solicitation clauses are legal under Mexican law. However (and as to avoid antitrust issues), non-compete arrangements should be limited in scope (to specific goods/services), time (generally, two to three years, and up to five years in specific scenarios) and territory (limited to specified areas).

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?

Mexican law bars (1) entities, and (2) individuals that are barred from carrying out business activities from serving as directors. In the case of publicly traded entities, statutory auditors are also barred from acting as directors within the 12 months following the date on which their auditor appointment expires.

As a rule, directors are not liable for any losses incurred by entities, unless such losses or damages are the result of wilful misconduct or gross negligence by such directors. Directors shall be jointly liable with entities for the following matters: (1) payment of equity contributions by shareholders/partners; (2) compliance with payment of dividends; (3) existence and maintenance of accounting and records; and (4) compliance with shareholder/partner resolutions.

A breach of these duties would entail liability by directors. Notwithstanding, directors shall not be liable, nor will any claim be exercisable against them, if, during the deliberation of the act for which a liability is being claimed, such directors voted against the execution or transaction, unless there is evidence of fault or wrongdoing by such director.

Special liability also exists for directors under Mexico's civil and criminal codes, and tax, antitrust, data protection, environmental, anti-money laundering/anti-bribery and corruption ("AML"/"ABC") and insolvency laws.

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?

Mexican law requires directors to: (1) to refrain from voting in matters in which they have a conflict of interest; and (2) treat all information and matters that come to their attention as confidential, unless such information is publicly available or if required to disclose the information by a judicial or administrative authority.

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?

Generally speaking, transaction timetables will vary depending on the nature of the transaction and the underlying business.

Merger clearance is required to the extent the transaction meets certain thresholds (deal value, participant size, and concentration of assets). Merger clearance is almost always jointly requested by both parties to a transaction and is typically structured as a condition to closing. This is based on the understanding that "hell or high water" mechanisms are not common in Mexico.

With respect to foreign investment limitations, Mexican law sets forth certain restrictions applicable for few strategic activities and sectors, which are reserved to: (1) government agencies (e.g., nuclear energy generation, exploration and extraction of oil and hydrocarbons, currency printing, coin minting); (2) Mexican companies with no foreign investment (e.g., land passenger or freight transportation); and (3) Mexican companies where foreign capital ownership is limited to a certain percentage (e.g., manufacturing of explosives or firearms, radio broadcasting). Foreign investment in other specialised sectors may be subject to prior authorisation by the National Foreign Investment Commission (e.g., private education).

As a rule, private equity investors are not required to register before (or obtain clearance from) the securities regulator in Mexico (Comisión Nacional Bancaria y de Valores ("CNBV")). Moreover, private offers are not subject to clearance from the CNBV so long as these (among others): (1) are exclusively made available to institutional or qualified investors, and, when dealing with equity/membership interests or unregistered securities representing the corporate capital of companies, if such securities are offered to less than 100 investors; and (2) are not solicited, offered or promoted to an indetermined person or by mass media communication platforms, and such solicitation, offering or promotion is not conducted on a professional or regular basis.

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

There is no specific official data in Mexico to determine these trends. That said, based on our experience, private equity in Mexico has recently increased, specifically with respect to venture capital, growth and leveraged buyouts, and real estate.

We have also seen an increase in minority investments undertaken by financial sponsors (equity investments with certain minority protections or debt-like investments with rights to participate in the equity upside) or a mixture thereof.

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 most relevant challenge for this type of transactions would be that the acquisition of a public company would require to be conducted by means of a public tender offer. For such purposes, the transaction will be subject to disclosure in the relevant stock exchange of information regarding the transaction and, likewise, would be subject to a lengthy scrutiny and authorisation process from the CNBV. Such disclosure and approval requirements represent significant delays and costs associated to the purchase and sale process. Furthermore, additional regulatory requirements may apply considering the transaction's structure and market share of potential buyers.

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

Regarding acquisitions of public companies, Mexican law allows to provide for no-shop protections in the transaction documents. Most common protections for this type of deals range from piggyback registration rights for investors, to even (less common) break-up fees or obligations to cover aborted deal costs.

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 no general rule in Mexico with respect to pricing mechanisms; that said, traditional pricing mechanisms to closing accounts are seen more often than "locked box" mechanisms.

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?

Representations, warranties and indemnities are given by the target company and seller, and are usually fully fledged when involving a material equity percentage, and include, among others, title to assets, capacity, compliance, due authorisation, no contravention, tax, financial information, litigation, labour, etc. On the buy-side, these are usually limited to capacity, due authorisation, and financial solvency. Representations and warranties are also usually subject to the existence of a "material adverse effect".

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 transactions where signing and closing are differed, conduct of business clauses, whereby the target company and seller agree to comply with certain positive and negative covenants to protect buyer, are common.

Indemnity clauses are usually divided into those arising from breaches to fundamental representations and warranties, and all other breaches. The caps, baskets (deductible and *de minimis*) and claim periods will depend on such type of breaches. Breaches will typically be exempt if fully disclosed. Sandbagging/anti-sandbagging mechanisms can also be included.

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

The use of representation and warranty insurance is not common in Mexico. When seen, it is usually in the context of larger cross-border transactions with foreign investors.

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 explained in question 6.3 above, caps, baskets (deductible and *de minimis*) and claim periods are usually negotiated and required by sellers.

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)?

Holdback mechanisms and escrow accounts are commonly used in respect of indemnities. Release mechanics for these are usually tied to statutes of limitations and/or representation and warranty survival periods.

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 structuring of acquisitions by private equity investors through SPVs is common in Mexico. To provide comfort to buyers, guarantees (*obligación solidaria*) by parent companies or ultimate beneficial ownership are often put in place, giving sellers a direct claim in case of a breach by buyer.

Equity and debt commitment letters are also used to provide comfort to sellers that investors will ultimately have the funds required to carry out the acquisition.

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

Seller (reverse) break fees are uncommon in Mexico. Breaches to seller's obligations are usually covered by the seller's indemnification obligations.

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 most relevant features or challenges to be considered by private equity sellers in an IPO exit would be: (i) the liquidity of the Mexican equity securities market; (ii) disclosure and scrutiny process; (iii) applications and approvals required from the CNBV; and (iv) timing and costs associated and connected with the IPO process.

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

It is customary to see lock-up agreements imposed on private equity sellers limiting or restricting the sale of shares for a certain period following the IPO. In our experience, such period typically ranges 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?

Even though a dual-track exit process is allowed in Mexico, this type of alternative for equity sellers is not common in our market. Some of the main factors are markets conditions, size, and resources to prepare for both, an IPO and third-party exit process.

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 (including the syndicated loan market, private credit market and the high-yield bond market).

When debt financing is structured locally, the most common form would be a term loan granted by a local party. Having said that, the finance market in Mexico is not limited to local institutions. Access to the offshore finance market is very common for Mexican transactions. Syndicated loans are regularly seen with a wide range of international parties participating in the syndicate.

A local high-yield bond market, even when developed, faces different challenges due to the timing and costs associated to the approvals required by the CNBV. Nonetheless, issuers and investors can also access offshore markets for these purposes.

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?

We do not identify relevant legal requirements or restrictions to structure debt financing.

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

A very notorious trend for debt-financing market in our jurisdiction would be environmental, social and governance ("ESG") financing. Since 2020, Mexico has seen a significant increase in the number of transactions involving ESG financing and ESG bonds. As a result, relevant regulatory efforts are already in place (Taxonomía Sostenible de México), as well as the development and sophistication of a special ESG financing market being on the rise.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

For investments made by publicly traded funds (in particular CKDs or CERPIs), continuation vehicles are somewhat used due to the fact that delaying liquidity for a long period could have a material adverse effect on the tax structure of the legacy fund.

9.2 Are there any particular legal requirements or restrictions impacting their use?

For CKDs, it is common for the fund to have detailed rules on how assets should be valued and divested, further limiting the manager's options in the use of continuation funds (use of third parties, external auditors, disclosure to the markets, etc).

In all cases, typical conflicts of interest restrictions should be observed.

10 Tax Matters

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

There are no transfer taxes or value-added taxes payable in respect of share acquisitions. Nonetheless, a seller may be required to pay income tax on the capital gains arising from the sale. The tax rate and potential withholding obligations for a buyer will apply on a case-by-case basis depending on the particular characteristics of the parties (e.g., individual or corporation, residency, equity participation, access to tax reliefs or exemptions pursuant to double taxation treaties, etc.).

Potential investors may also acquire shares of target companies via a direct subscription of (new) stock. This is a structure where one or more investors decides to participate in the equity of a Mexican company without a transfer of stock by the current shareholders, only their dilution, which generally should not trigger a tax event.

Offshore structures remain common in the Mexican private equity industry; however, as a result of recent changes to local law, as of fiscal year 2021, fund managers have favoured the use of local vehicles to structure private equity funds (trust or joint venture agreements) in order to preserve tax transparency for private equity investors.

Private equity investors are usually required to provide diverse information to fund managers in order to apply tax treaty benefits or claim tax exemptions (i.e., tax residence certificate, granting of a tax payments on account (POA), incorporation documents, among other requirements).

10.2 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 compensation arrangements usually involve the granting of stock options, warrants, earn-out payments and other forms of performance-based compensation to key members of management.

10.3 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 general, the sale or roll-over of stock owned by Mexican tax-resident employees creates a tax event. The applicable tax rate will hinge on the income bracket of the specific executive, but it will usually range between 30–35%. Likewise, executives that are tax residents in Mexico and who hold on to stock will be subject to a 10% withholding tax on dividends received.

Any other form of incentive scheme involving a cash payment to management such as earn-out or performance-based compensation will likely be subject to income tax at a 30–35% rate.

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

The tax reform bill enacted for the year 2021 modified tax-transparency rules for private equity funds, thus, many funds

migrated to the use of local vehicles (trust or joint venture agreements) to maintain their tax-transparent status.

Private equity funds that are effectively managed from abroad are generally able to apply a tax incentive available in Mexico in order to maintain transparency for Mexican tax purposes.

Other significant changes were incorporated in the Mexican rules applicable for the granting of a tax POA by non-residents. In general, if foreign investors of a private equity fund are required to grant a POA to a Mexican resident in order to pay taxes in Mexico on their behalf, solvency requirements must now be met for the POA to be valid for tax purposes (this includes scenarios where tax treaty benefits are being sought).

11 Legal and Regulatory Matters

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

Yes. In Mexico, multiple legal and regulatory developments have happened over recent years, impacting private equity investors. For instance, in 2023, different guidelines applicable to pension funds (principal institutional investors in the Mexican securities market) came into effect forcing such pension funds and their managers Retirement Funds Administrators (*Administradoras de Fondos para el Retiro* "AFORES") to have specific guidelines and policies to considering ESG factors in their portfolios and investments. Likewise, different amendments to our labour laws and regulations have passed in connection with outsourcing structures, labour unions, minimum wages and personal time-off representing different cost implications and legal challenges to investors. In addition, the most relevant amendment to the Securities Market Law (*Ley del Mercado de Valores*) since 2014 is expected to pass in September of 2023, which will introduce, among other things, a new type of public offerings in Mexico called "simplified public offerings" (*ofertas públicas simplificadas*), which are intended to boost the Mexican securities market and the number of issuers in Mexico by providing a more flexible regime to conduct public offerings of equity or debt registered securities.

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

No enhanced regulatory scrutiny for private equity investors is yet applicable in Mexico.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

No detailed legal or regulatory framework exists in Mexico in respect of impact investment strategies.

11.4 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 requirements and timeframes will vary depending on the scope of the underlying business and specific requirements of the relevant private equity investor. Bare minimum due-diligence exercises will cover corporate, contractual, financing, tax, labour and employment, IP, environmental and regulatory, and AML/ABC compliance matters.

11.5 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.)?

Recent amendments and additions to Mexico's legal and regulatory framework in respect of AML/ABC have increased investor's focus on broad diligence requirements. Moreover, detailed covenants and policies in respect of compliance, AML/ABC, fraud prevention and compliance with sanctions are commonly adopted.

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

Generally speaking, there is no piercing of the corporate veil, except in certain cases for specific tax and criminal situations (i.e., shareholders'/partners' liability is limited to their equity contributions). Note that the corporate veil is afforded to shareholders/partners and not to directors, who, as explained above, are personally liable towards the entity and its shareholders/partners.

12 Other Useful Facts

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

A relevant factor in private equity operations in the Mexican securities market and key to raising capital relates to CKDs. CKDs are fixed-term equity instruments that represent a property right over assets that a trust vehicle has obtained through a restricted public offering on a stock exchange for institutional investors (mainly pension funds) and qualified investors (with capital invested in securities in the last year greater than approximately USD 8.5 million). The CKDs are issued by a trust constituted under the laws of Mexico through a banking institution that acts in its capacity as fiduciary entity.

In general, a specific period is foreseen to carry out investments and, once said period is over, the CKD can no longer carry out new investments and enters a phase of divestment. Once the certificate expires, the investor will receive the face value of his security, plus any outstanding yield. Compared to floating or variable income securities, income depends on the returns of the projects in which the CKD invests. Although profitability is not guaranteed, it is expected that the asset will maintain constant flows.

The CKD trust may invest the proceeds of the issuance in various non-exclusive assets, such as technology, infrastructure, energy, real estate, among others, through the acquisition of participation in companies or trusts tax residents in Mexico (the "Project Companies") owning the same assets, as well as can grant loans to the Project Companies if their investment thesis provides for it, in this case considering the collection rights as assets of the CKD.

It is possible that the sponsor participates in the issuance by holding or acquiring a portion of the CKDs. The trust may issue different series of CKDs.

In relation to corporate governance, the trust issuer of CKDs has a holders' meeting in charge of approving the changes and investment policy of the trust. The assembly has the power to approve investments that they intend to make when they represent 10% or more of the trust's assets. Additionally, the technical committee has the power to approve the proposals of the administration to carry out investments.

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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 forms of private equity ("PE") transactions in Nigeria have traditionally been leveraged buyouts (by way of share or asset acquisitions), and expansion/growth capital. The market has, however, seen an uptick in venture capital ("VC") and bolt-on acquisitions in the last couple of years, particularly in the fintech space.

Despite the worsening macro-economic indices (the National Bureau of Statistics ("NBS") in fact reported that the investment inflow in 2022 was at its lowest in six years), PE transactions in Nigeria maintained an upward trajectory in 2022, with investor activity in sectors ranging from telecommunications, banking, waste management (recycling), financial services, fintech, information technology, oil and gas, and projects, amongst others. In 2022, 320 deals worth US$5.7 billion were recorded in the aforementioned sectors. Seed/Series funding and Venture rounds were the most popular, with 86 deals valued at US$886.3 million and 37 deals valued at US$50 million, respectively. Notably, the fintech sector recorded the highest deals valued at US$777.3 million. Whilst Q1 2023 showed a dip in activity, largely due to the uncertainties around the elections as well as foreign exchange ("FX") liquidity challenges, market indices suggest a rally, post elections, and increased investor confidence.

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

Factors encouraging PE investor activity in Nigeria include: large population size, growing consumer demographics and increasing regulatory clarity – via restructuring of the oil and gas sector under the Petroleum Industry Act of 2021; operational reformation of the landscape for financial technology by the Central Bank of Nigeria ("CBN"); reform by the competition commission by the introduction of various guidelines and guidance notes, thus bringing certainty to mergers and acquisitions ("M&A") and antitrust processes; recognition of PE-friendly corporate structures such as the LPs and LLPs by the Companies and Allied Matters Act of 2020 ("CAMA"); and increased governance flexibility with single member and single director companies, amongst others. In addition, the Federal Government's Ease of Doing Business Initiative ("EoDBI") with the aim to improve the business climate in Nigeria has driven the enactment of the Business Facilitation (Miscellaneous Provisions) Act, 2022 ("BFA"), which amends principal business-related provisions in legislations such as the CAMA, the Financial Reporting Council Act, Foreign Exchange (Monitoring and Miscellaneous Provisions) Act ("FEMMA"), Investment and Securities Act ("ISA"), Nigerian Investment Promotion Commission Act ("NIPC Act"), Nigerian Oil and Gas Industry Content Development Act, National Office for Technology Acquisition and Promotion Act amongst others. The enactment of the Nigerian Start-up Act 2022 creates a favourable business environment for startups by providing incentives and developing an ecosystem for startups to thrive.

From a tax perspective, tax reform also continues to be targeted at encouraging investment. The Finance Act 2021 designates Real Estate Investment Trust Scheme ("REITS") and Unit Trusts as pass-through vehicles for tax purposes, to encourage investment through those asset classes, while the Finance Act 2019, had earlier introduced exemptions to Excess Dividend Tax rule, to avoid double taxation. The Venture Capital Incentives Act, whilst not new, has recently re-entered the spotlight as it provides significant tax incentives in relation to start-up investments. The dispute resolution framework also continues to evolve with the Lagos Court of Arbitration emerging as the highest ranked court of arbitration in Africa, in a study by White & Case and the Queen Mary University of London. A revised Arbitration and Mediation Act has also recently been passed by the legislature and is expected to improve the seamlessness of the arbitration process in Nigeria.

Despite the overall positive outlook, the general global trend of rising inflation, geopolitical risks and other fiscal pressures continue to be a hindrance and to influence the way transactions are executed. For instance, there has been an increasing shift to debt and quasi-equity transactions, as investors attempt to hedge their risks. It is also expected that more investment activities will be witnessed following the 2023 Nigerian general elections.

Regulatory-wise, regulatory bottlenecks as well as steep fees for regulatory approvals (sometimes running into hundreds of millions) continue to be an issue. Additionally, the Finance Act

2021 removed the exemption of share transfers from capital gains tax, imposed excise duty on non-alcoholic, carbonated, and sweetened beverages (aimed at discouraging excessive consumption of beverages associated with excess sugar-related illnesses), and increased the Tertiary Education Tax to 2.5%, amongst others; it remains to be seen how these changes will impact deal structuring going forward.

1.3 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.

Angel investors, family offices, institutional investors such as sovereign wealth funds and development finance institutions, and more increasingly, VC firms, execute PE-style transactions across the value chain, with VCs and Angel Investors focusing on start-ups, whilst family offices and institutional investors are more interested in growth-stage investments. We have seen an increase in PE/VC partnerships – for instance the Verod-Kepple Africa Ventures; as well as in co-investments. This has allowed PE firms to broaden their investment appetite by leveraging on the expertise that VC firms have in early-stage valuation/investment. There has also been increased focus on crowdfunding as alternative financing, particularly with the introduction of the SEC Rules on Crowdfunding. However, given that only micro, small and medium-sized enterprises can raise funds under the SEC Crowdfunding Rules and the maximum that can be raised is NGN 100 million, we do not view crowdfunding, as currently structured, as a viable alternative. It remains an area to be watched though, with Obelix, a SEC-regulated Crowdfunding Intermediary, fundraising NGN 100 million for three small and medium-sized enterprises ("SMEs") in just 10 days earlier this year.

Some of these alternative financing sources can take longer-term positions than the traditional PE firms with five to seven years' investment lifespan. The VC and HNI investments are also characterised by reduced due diligence investigations and speed of execution.

2 Structuring Matters

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

Transactions are typically structured as bilateral acquisitions implemented via an offshore-registered special purpose vehicles ("SPVs"), which act as the holding company for a chain of portfolio companies. As noted earlier, worsening macroeconomics, election uncertainty, and risk management concerns have also recently led to an increase in quasi-equity and debt transactions or equity/debt combinations.

In early-stage investments, there is also increasing acceptance of the use of standard form agreements such as Simple Agreements for Future Equity ("SAFEs"), for convenience and flexibility.

2.2 What are the main drivers for these acquisition structures?

Main drivers for acquisition structures remain: control; profit maximisation; tax efficiency for investors and/or the post-acquisition group; FX liquidity issues; risk mitigation; exit prospects and ease of exit, lender requirements; and, in certain cases, sector-specific regulatory requirements, such as local content restrictions.

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 for equity contributed by PE investors typically consists of a combination of one or more of ordinary share capital, shareholder loans (which may be convertible), and preference shares.

Management equity is usually structured as ordinary shares, usually subsidised in the form of sweat equity or management incentive scheme, although there are cases in which management will inject capital.

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 the portfolio company level. Management incentives tied to performance or returns for the PE investor at exit are, however, common.

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

The structuring considerations are the same as those outlined in question 2.2 above. The measures put in place to achieve control will, however, differ, as transaction documentation and constitutional documents, will typically be required to entrench standard minority protections, including prescriptions as to voting and quorum arrangements, information and access rights, rights to appoint key management team, membership and nomination rights in boards and committees of the target company, board members' and shareholders' rights (including those that translate into veto rights) in certain key decisions.

Such restrictions may also have an impact on transaction approvals, as minority protections that are deemed to confer an ability to materially influence the policy of the target will trigger control thresholds pursuant to the Nigerian antitrust commission, Federal Competition and Consumer Protection Commission ("FCCPC") regulations and bring such transaction under its purview.

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 is between 5–10%; however, this usually varies from transaction to transaction and is generally lower in larger transactions. Provisions in the transaction documents may provide for compulsory acquisition triggers tied to whether a management officer holding equity is a good leaver or a bad leaver. Also, vesting triggers typically include achievement of key performance indicators, successful exits, or length of service.

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

In Nigeria, a management equity holder is regarded as a good leaver where his/her employment is terminated by reason of

retirement, death, or disability, and regarded as a bad leaver where the employment is terminated on the grounds of breaches such as fraud, specified grounds of misconduct, other criminal or civil offences.

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?

These arrangements are usually set out in the shareholder agreement or other investment agreement. Typical governance provisions include board and committee nomination and composition, appointment and removal of management team, quorum for board and shareholder meeting, information and access rights, veto rights and reserved matters, and shareholding control rights, amongst others.

There is no requirement for the governance arrangements set out in transaction documents to be made publicly available. Whilst disclosure of such documents to the regulator may be required in connection with obtaining regulatory approvals or notifications, (including antitrust and sector-regulatory approvals), other than the summary of the transactions, which might be published by such regulator, confidential transaction details including any governance arrangement will typically not be published.

However, the constitutional documents (memorandum and articles of association) of the portfolio companies are public documents. Critical governance arrangements/provisions (board composition, quorum, notice period, etc.) that are typically included in the articles of association are thus matters of public record.

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 and nominee directors are usually conferred with veto rights as part of the governance arrangement for decisions on acquisitions and material disposals, mergers, capital raise (debt or equity), business plans, related party transactions, appointment and removal of auditors, incentive arrangement for the management team, amongst others.

The above are the typical veto rights taken by PE investors with a majority and minority shareholding interest of at least 15% and above for private or unlisted public companies. For shareholding interest below 15% in private companies (which is unusual for PE transactions), there are rarely veto rights available to the PE investor.

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

The contractual agreement of parties (including veto rights) will generally be respected. This is, however, subject to statutory restrictions. Any veto arrangements that prescribe a lower threshold than that prescribed by the CAMA and the constitutional documents of portfolio companies cannot be enforced. Similarly, the CAMA prescribes minority shareholder rights that may be invoked notwithstanding existing veto arrangements. Section 343 of the CAMA specifically sets out acts in respect of which a minority shareholder may bring an action to restrain a controlling shareholder from abusing its dominant position. These include: entering into any transaction that is illegal or *ultra vires*; purporting to do by ordinary resolution any act that by its articles of association or the CAMA requires to be done by special resolution; any act or omission affecting the applicant's individual rights as a shareholder; committing fraud on either the company or the minority shareholders; where a company meeting cannot be called in time to be of practical use in redressing a wrong done to the company or to minority shareholders; where the directors are likely to derive a profit or benefit or have profited or benefitted from their negligence or from their breach of duty; and any other act or omission, where the interest of justice so demands.

In addition to the foregoing, Section 353 and Section 354 of the CAMA also allow a minority shareholder to bring a petition to the court on the grounds that: the affairs of the company are being conducted in a manner that is oppressive, unfairly prejudicial to, or unfairly discriminatory against a member or members, or in a manner that is in disregard of the interests of a member or members as a whole; or that an act or omission was or would be oppressive or unfairly prejudicial to, or unfairly discriminatory to a shareholder or shareholders.

Also, at the director nominee level, every director stands in a fiduciary relationship towards the company and is expected to observe utmost good faith towards the company in any transaction with it or on its behalf and act in the best interest of the company. This is so even when such a director is acting as the agent of a particular shareholder; specifically, a director is not to fetter his/her discretion to vote in a particular way. The statutory duties and fiduciary relationship imposed on directors are not relieved by any provisions in the articles of association or any contract.

In addition to the foregoing, Nigerian law does not recognise weighted or non-voting shares.

Parties can protect the enforceability of veto arrangements by ensuring that critical veto arrangements are included in the articles of association (to the extent permissible in the CAMA); equally considered at shareholders' level (to avoid fettering directors' discretion), and in line with applicable 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?

PE investors may owe contractual duties and obligations to minority shareholders such as management shareholders arising from and as agreed in relevant investment agreements. Statutorily, a PE investor owes no direct statutory duties or obligation to any other shareholder; however, the CAMA, other applicable laws, and constitutional documents of portfolio companies confer individual rights on every shareholder (e.g., right to notice, dividends, voting rights, etc.) and provide mandatory rules for management and operation of companies. Non-compliance with these by a company (through a controlling/majority shareholder) will provide any shareholder with a cause of action. Please refer to question 3.3 above.

In addition, relevant corporate governance codes require the protection of rights of all shareholders including minority shareholders' rights.

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

Generally, Nigerian courts will recognise and enforce the provisions of shareholder agreements based on the principle of contractual autonomy of parties. However, there are instances where the enforceability of the provisions of a shareholder agreement will be subject to mandatory provisions of applicable Nigerian law, such as highlighted under question 3.3 above. In this regard, only damages for breach of agreement may be the most successful outcome of an enforcement action.

With regard to governing law, Nigerian courts will generally enforce parties' choice of law. However, where the choice of law is a foreign law, the courts have held that such foreign law must not be unreasonable, absurd, or capricious and must have some relationship to and be connected with the realities of the agreement. Choice of foreign law will not be applied in domestic subject matters such as tax, environment, antitrust, management and operation of corporations, etc. Similarly, based on precedents, courts will generally respect parties' choice of jurisdiction, save for where it is considered an attempt to oust the jurisdiction of the Nigerian courts over a matter or there are strong reasons to suggest that justice would not be done (considering such factors as the jurisdiction where evidence is available, parties' choice of law, the connection of the court to the parties, contractual limitation period, procedural advantage by either party, enforcement of judgment, etc.).

Non-compete and non-solicitation provisions are equally enforceable subject to terms imposed by appropriate competition and consumer protection laws in respect of non-compete provisions. For instance, the Federal Competition and Consumer Protection Act, 2018 ("FCCPA") limits non-compete provisions to a period of two years, and prohibits any provision that would operate to prevent, restrict, or distort competition.

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 CAMA and corporate governance codes have specific qualifications and requirements to be satisfied prior to appointing any nominee/person to the board of a Nigerian company. These range from mental ability, age, absence of fraudulent acts, to bankruptcy status. In addition, certain sectors, such as financial services, require minimum qualifications and regulatory approval for persons nominated as directors. There are also restrictions on multiple directorship positions and dual role, e.g., licensed financial institutions are most times required to separate the role of a chief executive officer and chairman on the board. This is also a general restriction in most codes of corporate governance. In addition, the BFA places a restriction on the number of public companies a person can act as director for and provides that the required numbers of independent directors in a public company shall be at least one-third of the size of its board.

As highlighted in question 3.3 above, directors have statutory (fiduciary) duties to the company. A breach of any of the statutory duties can result in personal liabilities for such a director. In addition, certain regulations, like the CBN Administrative Sanctions Regime applicable to banks and OFIs, impose specific liability (both civil and criminal) on directors of the company for specific breaches.

For PE investors, liabilities of its nominated director will not be imputed to it. However, by agreement, the shareholders may agree for a nominating shareholder to be liable for loss incurred by its nominee director.

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 director's statutory duties and fiduciary relationship with the company trumps his/her obligation to a nominating shareholder and directors must always act in the best interest of the company.

Where a director occupies more than one directorship position, he/she must not derogate from his/her statutory duties and fiduciary relationship with each company. Such director is not to use the property, opportunity or any information derived during his/her management of one company for the benefit of the other company. In anticipation of conflict of interest from multiple directorships, the Nigerian Code of Corporate Governance and sector-specific codes generally discourage multiple directorships and require disclosure where they exist.

Typically, where either actual or potential conflict of interest arises, the affected director is expected to disclose and, where applicable, recuse himself from voting on such transaction.

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 issue that typically impacts transaction timelines relates to regulatory approvals and/or wait periods. For instance: merger control approvals from the FCCPC may take between four and 18 weeks depending on the classification of the merger/scope of filing; barring any bureaucratic delays, approvals from the Securities and Exchange Commission ("SEC") may take between six and eight weeks; approvals from the CBN may take between 12 and 16 weeks; approvals from the Nigerian Exchange Group ("NGX") may take between one and two weeks; approvals from the National Insurance Commission may take between 10 and 12 weeks; and approvals from the Nigerian Communications Commission may take between four and 12 weeks. Often, these approvals are also contingent on having obtained a prior approval or require notice or wait periods, thus further lengthening time periods. Other factors that typically cause transaction delays include delays with raising transaction financing or conducting due diligence. Transactions can be completed fairly quickly where they are not complex, involve parties and professional advisers with sector expertise, network and compliant/organised targets (with up-to-date and available records), and require few or no regulatory approvals.

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

In recent times, there is a trend towards a risk-based approach to due diligence. PE investors are also increasingly taking a

minority stake, with terms allowing them to increase their stake as events pan out. Transactions are being increasingly structured as a mix of equity and debt or quasi-equity as PE investors attempt to de-risk these transactions in response to foreign currency volatility, global macro-economic and other challenges. In addition, there has been increased attention paid to Material Adverse Change/Effect ("MAC"/"MAE") clauses, liquidation preferences and the extent of the potential impact on and protection for the governance and financials of portfolio companies and the investment at large. Deferred consideration structures are also being more creatively packaged in the form of earnouts, etc., rather than the traditional escrow structures.

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?

Challenges prevalent in public-to-private acquisitions include:

(i) regulatory consents and authorisations required for such transactions, including the cost and the timing for obtaining same;

(ii) the cost of the transactions as well as the funding structure (for example a public-to-private transaction is usually more costly where a leveraged buy-out structure is used);

(iii) shareholders' voting/approval (i.e., minority shareholders engagement/management); and

(iv) employee and employee associations interests.

Deal timing, due diligence, transaction structure/documentation, and consideration (all-cash offer, part-cash/part-equity, escrow, etc.) are other hurdles to surpass. To navigate these issues effectively, parties tend to engage the respective regulators at the beginning of the transaction to discuss structure and transaction exigencies. Furthermore, parties sometimes adopt transaction structures that assure transaction certainty, such as a scheme of arrangement. The quality of advisers engaged by the parties and the pricing of the deal also assist in mitigating completion risks. Finally, public to private transactions generally entail extensive stakeholder engagement across the diverse interests particularly minority shareholders and employees.

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

Generally, aside from the specific issues that may be uncovered upon carrying out detailed due diligence, PE investors typically protect themselves by adopting deal structures that isolate portfolio liabilities. A number of the protections are negotiated directly with the selling shareholder(s) and include representations and warranties, indemnities, the use of escrow structures, the use of custodian arrangements, deferred consideration, insurance, participation rights, information rights, break fees, exclusivity, 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?

Cash structures have been traditionally preferred by both buy and sell sides, with the locked box structure being the most adopted structure. There is, however, a recent push for a completion accounts consideration structure by buyers, which may not be unrelated to the trend towards red flag due diligence. Share swaps representing a portion of the consideration are also not uncommon, particularly where the expertise rests on or the brand is associated with the seller. Earnout arrangements are also being increasingly proposed and adopted in primary acquisitions (i.e., from the founder/managers).

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 will typically push back on anything but fundamental warranties – title, capacity, authority, and pre-closing tax liabilities – and may insist that founders/managers provide any business warranties required. This is, however, subject to negotiation, and it is not unusual for a buyer to push back and to elicit business warranties from PE sellers, particularly where they have a controlling stake. Management who are "founder/managers" are typically required to and do provide both fundamental and business warranties. It is, however, unusual for the management team in its capacity as management simpliciter to offer 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?

This is subject to negotiation but would usually be expected to include interim period undertakings as to actions between signing and completion, undertakings as to "no-leakages" (for locked box transactions), undertakings to cooperate in relation to regulatory filings, and in certain circumstances, information undertakings. Generally, PE sellers will resist any covenants or undertakings creating restrictions on their capacity to freely invest in competing businesses, whilst founder/managers would typically expect to be required to give such covenants.

Seller indemnities are commonplace, although PE sellers will typically push for the buyer to price most of the risk in, and thus seek to limit the scope of those indemnities. Please refer to question 6.5.

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?

Taking out representations and warranties insurance is not common in Nigeria, although it has been utilised in some deals by offshore PE investors and is increasingly being considered a risk mitigant, particularly for larger transactions. The cost is, however, quite high, and the time implications (from a due diligence perspective) can also be discouraging. Standard exclusions include known risks identified during the due diligence, fraud or misrepresentation, tax liabilities, consequential losses, environmental matters, AML/CFT compliance, amongst others. Other than fraud-related exclusions, parties are typically able to negotiate to price in excluded risks. Policy limits, typically, are in line with what has been agreed in the SPA.

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

Exiting PE investors and management typically seek to contract out of statutory time limitations by inserting limited periods by which claims can be made (usually between six and 24 months, for non-tax warranties). Other limitations include floors/materiality threshold and *de minimis* claim levels (individual and aggregate), caps on financial exposure, knowledge and materiality qualifiers, disclosures and liabilities being on a several (*pro rata*) basis.

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 will usually insist on security where the seller is not considered creditworthy or claims might otherwise be difficult to redeem (for example, an individual, trust or SPV entity, or entity domiciled in an "unfriendly" jurisdiction). PE sellers and management will usually push back on providing security; subject to the considerations stated above; however, security that might be provided includes retention amounts in escrow, security over founder/manager shares (where their exit is not total), and (in rare cases) personal guarantees. Some institutional buyers such as investment funds (and particularly infrastructure funds) also tend to request bank guarantees to secure their investments in infrastructure-based portfolio companies.

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 in relation to the availability of debt and equity funding may be provided by way of (i) escrow of committed funds (this was traditionally the primary form of security but is becoming less common), (ii) evidence of "certain funds" in the form of signed debt term sheets, (iii) equity commitment letter from the sponsor/parent (particularly where an SPV is utilised by the buyer), (iv) comfort letters in respect of debt financing from reputable third-party lenders, and, in fewer cases (v) letters of credit. Ultimately though, reliance is usually given to the reputation and financial standing of the buyer, and such evidence may not be required where the buyer is reputable and of good standing, in which case the seller may choose to rely on appropriate financial capacity warranties in the SPA.

Seller remedies will typically lie in damages and, where negotiated, reverse break fees.

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 historically prevalent in the Nigerian market but are becoming more common as buyers shy away from traditional protections such as escrow, and where sellers have committed time and resources to the deal.

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 exit timing, regulatory requirements, the cost of effecting the initial public offering ("IPO"), the valuation of shares following changes in share capital and the underwriting of shares not taken up. Furthermore, political risks, the macroeconomic conditions in the country, including the weakening of the Naira and shortage of foreign currency, and the impacts of the pandemic on businesses may also pose challenges to a PE seller considering an IPO exit. Indeed, in recent years, companies such as Interswitch, seeking to create exit via an IPO have had to postpone or consider alternative exit routes.

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

Pursuant to the provisions of the NGX Rulebook, promoters and directors of companies intending to undertake an IPO and list on any board of the exchange must hold a minimum of 50% of their shares in the company for a minimum period of 12 months from the date of listing and will not directly or indirectly sell or offer to sell such securities during the said period. Accordingly, PE sellers on an IPO exit will be required to comply with this provision of the NGX Rulebook, unless the requirement is waived by the NGX. Furthermore, agreements regarding the lock-up period and other management/transitional matters are usually entered into between the PE sellers and the listed company. PE sellers usually seek to avoid or minimise this requirement.

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 most common exit process in Nigeria is secondary sales to trade buyers. However, there have been instances where PE sellers have pursued dual-track exit process. A PE seller may continue to run a dual-track deal until it binds itself to a particular exit process (i.e., either a sale or an IPO). For instance, the terms of acceptance of a binding offer in respect of a sale transaction may preclude the PE seller from exploring other exit options. Given the drought of IPOs in the Nigerian market in recent years, it can be garnered that PE sellers who considered/pursued dual-track routes ultimately exit through 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 (including the syndicated loan market, private credit market and the high-yield bond market).

Debt finance for PE transactions has traditionally been by way of external debt/leverage provided by syndicate banks, institutional financiers and a range of alternative private credit providers. Credit support instruments and mezzanine financing

are also common sources of debt finance. Less common, but still applicable sources for PE investors include commercial papers (CPs), loan notes, bonds and investments in relatively high-yield instruments including treasury bills. The market has seen an increase in recourse to private credit as bank financing tightens, which is also due to the trend towards debt investment or a mix of debt and equity by PE investors.

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 the ability to repatriate principal and/or interest on foreign loans outside Nigeria utilising the official FX market, subject to having obtained an electronic certificate of capital importation from a CBN-authorised dealer when the original equity investment or loan capital is inflowed into Nigeria. This has given investors the ability to structure their capital inflow in accordance with their objectives/risk appetite. However, the Finance Act 2019 introduced clear thin capitalisation rules in Nigeria in the form of interest deductibility restrictions, restricting interest deductibility to 30% of EBITDA. Excess interest can also only be carried forward for five years, and we expect that this will have an impact on equity/debt mixes.

In addition, the CAMA expanded the scope of exceptions to the rule against financial assistance by Nigerian companies, thus granting parties greater flexibility in capital structuring.

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

Borrowers have continued to search for cheaper debt in the wake of the continued rise in interest rates. There has thus been a slow-down in syndicated lending, and more focus on alternative credit such as private credit. Telecoms, infrastructure, and sustainable investment such as renewable energy, recycling and upcycling have enjoyed popularity in this regard. Borrowers searching for cheaper debt have also led to a number of refinancings.

The Nigerian CP market has remained a viable funding option for corporate entities seeking to finance their short-term expenditure, including working capital shortfalls. The FMDQ Exchange reported that the value of quoted CPs on the Exchange stood at N 539.22 billion at the end of Q1 2023, with the total outstanding value of CPs rising to N 669.36 billion at the end of the same period.

Documentation wise, a number of banks are resorting to short-form documentation to reduce legal costs.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

The use of continuation fund vehicles or GP-led secondary transactions remains uncommon in Nigeria. However, given: (1) the rise in popularity in other markets; (2) the fact that such vehicles are no longer globally viewed simply as a means of moving unrealised (and difficult to exit) portfolio investments out of a fund that was at the end of its lifespan, but as healthy vehicles to extract more value from their best performing assets; and (3) the impact of the pandemic as well as macro-economic conditions that have meant that GPs have been unable to maximise returns during the hold period on otherwise well-performing investments, we expect that we may begin to see the use of continuation fund vehicles, particularly in sectors such as education.

9.2 Are there any particular legal requirements or restrictions impacting their use?

Please refer to our response to question 9.1 above. Besides the CAMA, ISA and rules, regulations and guidelines of the National Pension Commission regulating the establishment and operation of funds in Nigeria, we are not aware of any particular legal requirements or restrictions impacting the use of continuation fund vehicles or GP-led secondary transactions.

10 Tax Matters

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

The overriding tax focus for PE investors is the need to mitigate tax leakage, and to the extent possible, ensure that structures are flow-through in nature. More specific considerations include:

(a) Available tax incentives. Some of the tax reliefs available in Nigeria include double taxation relief – investors in countries with which Nigeria has a double taxation treaty enjoy tax reliefs of up to 2.5%, and exemption of capital gains tax ("CGT") from business reorganisations or transfers of assets within a group in the course of reorganisations, subject to a one-year minimum holding requirement.

(b) Taxes payable in connection with the investment, including taxes/charges payable in relation to the capital invested, taxes payable on the income or capital gains received on the investment or goods or services supplied in respect thereof, such as withholding tax on income, CGT, and value-added tax.

(c) Applicable corporate income taxes.

(d) Taxes payable for perfection of security/transaction documents such as stamp duties, and registration fees.

(e) Transfer-pricing-related risks. Where there are transfer pricing-related risks, the relevant tax authorities may flag the transaction and subject it to tax adjustments, which may increase the tax exposure of the investors in the transaction.

Offshore structures are common to minimise tax exposures and benefit from double taxation reliefs.

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

Management teams will usually be exposed to tax on two fronts – personal income tax at a proportional graduating scale, with rates ranging from 7–24% payable in respect of income received from the investment; and transfer taxes/CGT at 10% in relation to management's participation in equity growth through partial exits.

There is no tax exposure to management at the point of acquisition of its equity whether upfront or by way of deferred/vesting arrangements, nor are there any special waivers or incentives in relation to management disposals. Management may be able to obtain some tax relief by structuring returns on equity interests as service-linked gratuity payouts, although this is not common.

The Finance Act 2020 also exempts compensation for loss of office up to NGN10 million from capital gains tax.

10.3 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 primary consideration would be to avoid triggering transfer taxes in relation to the transfer, particularly for roll-overs, given that no gains will actually come into their hands at this point. For business reorganisations involving disposal or transfer of shares in a Nigerian company, 10% CGT applies except where the share disposal proceeds are: (i) reinvested within the same year of assessment, in the acquisition of shares in the same or other Nigerian company; or (ii) the share disposal proceeds, in aggregate, are less than NGN100 million in any 12 consecutive months, provided that the person making the disposal shall render appropriate returns to the Federal Inland Revenue Service ("FIRS") on an annual basis. Partial reinvestment will attract CGT proportionately. Re-investment offshore (as is often the case with management roll-overs) will not, however, attract this concession (except any of the other exemptions applies). (It may nonetheless be possible to engage the FIRS in the case of roll-overs, with a view to clarify that the same is simply an exchange of shares and therefore any transfer of shares ought to be exempted from CGT). This is a relatively new development and it is interesting to see how the market will respond.

10.4 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 Fiscal Policy Measure 2023 ("FPM 2023") took effect from May 1, 2023. The FPM 2023 provides for some operational tax that impacts investments in portfolio companies:

- Supplementary Protection Measures for the implementation of the ECOWAS Common External Tariff ("CET").
- Import Adjustment Tax ("IAT") list, with additional taxes on 189 tariff lines of the extant ECOWAS CET.
- Import Prohibition List (Trade), applicable only to certain goods originating from non-ECOWAS Member States.
- A National List consisting of items with reduced import duty rates to promote and stimulate growth in critical sectors of the economy.

Worthy of note are the provisions to encourage climate change interventions (green tax provisions), comprising:

- excise duty of 10% on single-use plastics, including containers, films, and bags;
- increase in IAT on the importation of other plastic items such as sheets, foils, polymers, and photocopying papers; and
- prescription of IAT of 2% on motor vehicles of 2,000cc to 3,999cc – while vehicles of 4,000cc and above will be taxed at 4% – and exemption of vehicles of below 2,000cc, mass transit buses, electric vehicles and locally manufactured vehicles from IAT.

The Nigerian Senate passed (and recommitted) the Finance Bill 2022 (the previous version passed in December 2022 by both houses had been amended by the presidency and re-sent for approval). Below are the relevant changes that pertain to PE transactions in Nigeria:

- Deduction of losses arising from sale of one asset from the gains derived from the sale of another asset of the same class. Accordingly, where a company sells shares and records a loss, the loss accruing from the disposal of those shares can be deducted against the gains derived by the company from the sale of other shares.
- Introduction of Digital Assets as Chargeable Assets under the CGTA.
- Increase in the Tertiary Education Tax ("TET") rate from 2.5% to 3%. It is instructive that the rate was only recently increased from 2% to 2.5% via the 2021 Finance Act.
- Expansion of scope of excise duty to cover services other than telecommunications.
- Removal of the investment allowance of 10% currently applicable to capital expenditure incurred on plant and equipment under section 32 of the CITA.
- Removal of the rural investment allowance ranging from 15% to 100% applicable to capital expenditure incurred on the provision of certain facilities such as electricity, water or tarred road for the purpose of a trade or business that is located at least 20 kilometres away from such facilities provided by the government.
- Removal of the income tax exemption applicable to 25% of incomes in convertible currencies derived from tourists by companies engaged as hoteliers.
- Provision for unrestricted deductions of capital allowances from assessable profits, for companies engaged in upstream or midstream gas operations.

11 Legal and Regulatory Matters

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

Yes. The last few years have seen a plethora of regulatory interventions, particularly as related to the ease of doing business, the financial services sector and competition and merger control. Some of such developments include:

- Amendments to 21 business-related laws, by the BFA in February 2023, removing bureaucratic constraints to doing business in Nigeria. Of specific note are the provisions introduced to foster transparency, certainty and speed, such as the requirement for all MDAs to publish clearly the processes, timelines and requirements for obtaining approvals, as well as the deemed approval provisions in which a regulator fails to communicate an approval or rejection within the prescribed timeline. The BFA is expected to introduce yearly updates as a more efficient way of introducing amendments that ease bottlenecks.
- The release of the Nigerian Startup Act, 2022, which supports startups through the provision of access to funding, tax breaks and intellectual property protection.
- Amendments to regulatory capital for microfinance banks and insurance companies, which spawned a number of M&A in the sector in 2020 and 2021.
- The release of the Merger Review (Amended) Regulations, 2021 by the FCCPC hot on the heels of the Merger Review Regulations and Merger Review Guidelines released in 2020.
- Regulatory focus on contracts or relationships in restraint of trade and market dominance abuse, through the issuance of the Restrictive Agreements and Trade Practices Regulations, 2021 and the Abuse of Dominance Regulations, 2022, by the FCCPC.
- Expansion of investment options for PFA "dry powder" through the release of the National Pension Commission's Operational Framework for Co-Investment by Pension

Fund Administrators, 2022 (historically, one of the asset classes with the lowest allocation by PFAs has been PE).

Tax reforms via the Finance Acts of 2019–2022 have also impacted PE investment, particularly exemptions to the excess dividend tax rule. (Please also refer to the response to question 10.4.)

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

100% foreign ownership of Nigerian businesses is permitted under Nigerian law, except in certain sectors where local content, such as in shareholding or makeup of workforce, is mandated by law. Some of these sectors include shipping, aviation, oil and gas, private security, broadcasting, and advertising, amongst others. Also, investing in the production of certain goods (e.g., arms and ammunitions, narcotic drugs, military, or paramilitary wear, etc.) is strictly prohibited by law for Nigerians or foreigners.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

The legal and regulatory framework for general investments in Nigeria also applies to impact investments and there are no additional legal or regulatory requirements to be complied with. The regulatory framework is, however, evolving to encourage impact investment with laws such as the Climate Change Act, 2021, and the provisions on Host Communities Development Trust under the Petroleum Industry Act of 2021. Older tax incentives such as the Pioneer Status Incentive also indirectly encourage impact investment.

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

This is relative to several factors, such as the scope of the transaction, nature and size of target, parties' objectives, and timelines of the transaction, amongst others. Key areas typically covered include the corporate structure, regulatory compliance, material contracts, debt and security, employment issues, intellectual property and other assets, insurance, tax and litigation profile. The market has seen an increasing shift to high-level red flag due diligence, although, in our experience, the more complex/larger transactions still adopt the granular approach.

The timeframe for legal due diligence may take between two and six weeks, depending on the scope of the due diligence and the availability of records, and accessibility to external regulatory and third-party records or confirmations.

11.5 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. The legislation impacting PE investment includes the Money Laundering (Prevention and Prohibition) Act 2022, the Terrorism (Prevention and Prohibition) Act 2022 and the CBN's Anti-Money Laundering and Combating the Financing of Terrorism in Banks and Other Financial Institutions in Nigeria Regulations (AML/CFT Regime). Contractual provisions on AML/CFT compliance have become more robust and typically extend to compliance with international requirements, such as the UK Bribery Act and the American Foreign Corrupt Practices Act.

Compliance/know-your-customer/integrity due diligence is also a more common phenomenon in PE transactions.

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

Generally, a shareholder in a limited liability company only bears liability to the extent of shares in his/her interest paid or yet to be paid. Nigerian law generally respects the concept of separate corporate legal personality, and it is only under limited circumstances that the courts would lift a corporate veil so that a director or a company may be considered liable for the acts of another company. Circumstances where executive management, designated officers of the company or the board of directors may be held responsible and sanctioned, include offences under the CBN Administrative Sanctions regime, which stipulates penalties for senior management and in some cases, members of the board, in addition to the company. Also, in the case of unlimited companies, the liability of the members for the debt of the company is unlimited.

12 Other Useful Facts

12.1 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 major obstacles for PE investment in Nigeria is the infrastructure deficit, which impacts the operations, profitability and ability to scale portfolio companies. However, the Infrastructure Corporation of Nigeria (touted as "Nigeria's Infrastructure Game Changer) debuted in February 2022. Infracorp was established with a start-up funding of NGN1 trillion for the construction of critical infrastructure projects to help accelerate growth in the country by originating, structuring, executing and managing end-to-end bankable projects. Its funding is expected to grow to NGN15 trillion; and assets will be managed by four independent asset managers with an impressive record in infrastructure development. Infracorp is promoted by the CBN, Africa Finance Corporation and the Nigeria Sovereign Investment Authority.

In addition to providing co-investment opportunities to PE investors, it is expected that the activities of Infracorp will have a positive effect on the market and ultimately the economy.

Nigeria also ratified the African Continental Free Trade Area Agreement ("AfCFTA") with effect from January 1, 2021; whilst gains remain slow to yield, and political commitment to scaling the hurdles appears to be more visible in speech than action, where properly implemented, AfCFTA will address the restrictions that have made it difficult to scale regionally.

In terms of economic outlook, the new administration, which took over on May 29, 2023, has announced the cessation of the fuel subsidy. This is expected to significantly drive up the cost of operations of portfolio companies, as well as the cost of living, thus leading to reduced spending power of consumers/clients. Another major focus of the administration,

as announced by the President, is the unification of the exchange rate. Whilst a unified exchange rate will ultimately increase efficiency, transparency and stability in the FX market and thus benefit FDI, these gains cannot be achieved without a supportive fiscal and monetary context. On the upside, the external reserves that were significantly depleted in 2022 are expected to grow in H2 2023, following the commissioning of the Dangote Refinery, the savings from subsidy removal being retained or invested in infrastructure, increase in oil production levels in Q4 2023, and the significant brain drain that is expected to increase foreign remittances.

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Norway

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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 initial public offering ("**IPO**") exits), in 2022, LBO transactions of private targets dominated the transaction volume, representing 46.2% of the total PE transactional volume for that year.

Throughout 2022, private equity firms started to experience increased headwinds with respect to leveraged financing, resulting in declining private equity deal activity despite significant dry powder. In 2022, the total Norwegian M&A market continued to increase in volume and was compared with 2021. Large deals were slightly up in respect of the percentage of the total M&A value but down in numbers compared with 2022, due to a significant drop in large deals in the second half of the year. The Norwegian PE market could, however, report a 10.1% increase in reported volume compared with 2021, but with a significant drop in average deal sizes, as well as a drop in number of exits. For deals involving PE Sponsors in 2022, (either on the buy- or sell-side) the average reported deal sizes dropped significantly from €334 in 2021, to €153 in 2022. The market continued to be driven by new investments and add-ons but, in 2022, we also witnessed a significant drop in the number of secondary investments.

As mentioned above, the Norwegian PE market spans the width of all transaction types found in any mature market, but the typical *club deals* have, save for a few exceptions, for all practical purposes been outside the realm of the Norwegian PE market. The main reason for this is that most Norwegian transactions are of a size that normally does not require a major international PE fund to spread its equity risk in order to avoid exceeding investment concentration limits in its fund. The foregoing notwithstanding, sell-downs or syndication of minority equity portions subsequent to buyouts also occur in the Norwegian market.

By the number of PE transactions, TMT, the industrial/manufacturing and the services sectors dominated the Norwegian market in 2022, each with 30%, 14.3% and 13.8% of the buyout investment volume, respectively. They were followed by the construction sector with 11.1% of the total deal count, the consumer sector with 8.5%, and the energy sector with 5.8%.

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. For the moment, the oil- and energy prices are once again on the rise, which is generally viewed as beneficial for the Norwegian economy. This time, however, increasing energy prices have come at a high cost due to supply chain disruptions, and pent-up demand following the COVID-19 pandemic as well as the war in Ukraine, which have collectively intensified the inflationary pressure. Increased inflation is currently also contributing to increasing interest rates, which again may lead to a recession in many European countries. Increasing inflation and interest rates, 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 in general, as well as for Norwegian targets.

1.3 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?

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 six 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. An increasing number of funds also seem to have obtained mandates to carry out minority investments in private companies subject to certain defined control criteria with respect to a possible exit.

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 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 11.1); 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 (47.4% 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 the taxation of Carry, see question 10.4.

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) 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; however, 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 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/Northern Ireland nationals who reside in an EEA state or in the UK/Northern Ireland. 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/UK/Northern Ireland 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. 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 11.1) 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, piercing 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, an increasing number of 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.
- The 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 start 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, but has in 2022/2023 so far come to a halt due to plummeting and volatile stock markets.

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 foregoing 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 and "wall-crossing" 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 notify the company and the OSE (which is authorised to receive such notifications on behalf of the Financial Supervisory Authority of Norway ("**Norwegian FSA**")). Note that the deadline for when disclosure must be made was amended in 2022 from "immediately" to "immediately, and no later than the opening of the regulated market on the second trading day" following the disclosure obligation being triggered. It is envisaged that the Norwegian FSA can come up with guidance explaining key typical cases and how these relate to the deadline. 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. It should be noted that certain amendments to the Norwegian disclosure regime have been implemented and will take effect from 1 September 2022 (*cf.* question 12.1). When dealing with shareholders directly in take-private transactions, a PE fund will also experience that shareholders are reluctant to grant extensive representations and warranties besides title to shares and the shares being unencumbered.

Another challenge in take-private transactions is that if a PE fund directly, indirectly or through consolidation of ownership (following a stake-building process or one or more voluntary offers) has acquired more than ⅓ of the votes in the target, it is (save for certain limited exceptions) obligated to make a mandatory offer for the remaining outstanding shares. After passing the initial ⅓ threshold, the fund's obligation to make a mandatory offer for the remaining shares is repeated when it passes (first) 40% and (then) 50% of the voting rights (consolidation rules apply). Please note that certain derivative arrangements (e.g. total return swaps) may be considered 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 the 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 them. 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 12 public M&A offers launched in 2021, a cost cover of up to NOK 10 million (around 0.1% of the offer price), reflecting an estimate of the cost incurred by the bidder, was introduced in one of these deals. In another deal, a cost cover of up to NOK 25 million (around 3.6 % of the offer price) was agreed and, in a third deal, a cost cover of up to EUR 1.8 million (around 1.2% 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 2022. 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, provided that 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 2022, 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 2022, we estimate that close to 12% of all M&A deals in Norway used this type of insurance, which in fact was a significant drop in the number of deals with W&I Insurance from 2021. The main reason for this reduction was the significant drop in average deal sizes for 2022 compared with 2021.

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 under-funding; 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 0.7% 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 are traditionally 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 the 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 the BidCo (by way of copies of a commitment letter or other form of promissory notes issued to the BidCo) will only be enforceable against the 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 the 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. During 2020 and 2021, we observed a significant increase in dual-track processes being materialised in an IPO, in particular on Euronext Growth Oslo (formerly Merkur Market). However, at the end of 2021 and throughout 2022, this trend came to a halt, with declining stock market prices. Nevertheless, entering 2023, we have seen a few attempts of dual-track processes being launched.

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 (including the syndicated loan market, private credit market and the high-yield bond market).

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 start of 2017 and throughout 2019, the Norwegian high-yield bond market improved significantly, at least within certain selected industries. At the start 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. Since 2022, the Norwegian bond market remains turbulent, with interest rates and credit spreads rising sharply. The Norwegian high-yield market continued to decrease throughout 2022, dropping from NOK 127 billion new issued bonds for 2021 to NOK 52 billion new issued bonds for 2022.

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 of 1 January 2020, certain further easing of the Norwegian financial assistance prohibition rule has 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 is implemented. 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, the requirement for the buyer (as borrower) to provide "adequate security" for its repayment obligation is no longer 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, provided that 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 is now 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.

From 1 July 2014, Sponsors must also ensure that they observe the anti-asset stripping regime that is set out in the Act on Alternative Investment Fund Managers (see question 10.2). These rules may limit the Sponsor's ability to conduct debt pushdowns, depending on the status of the target (listed or non-listed), the number of employees in the target and the size of the target's revenues or balance sheet.

Further, 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 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

For the last couple of years, there has been an increase in the use of so-called continuation funds also in the Norwegian market and, today, these funds are increasingly used by GPs to buy portfolio companies out of existing funds as they reach the end of their lives, in order to hopefully extract additional value from those assets. These funds have been around for several years, and used to be thought of as vehicles formed to restructure underperforming assets. The continuation vehicle is typically controlled by the same sponsor, while the pricing and terms of the transaction are generally among and negotiated by the lead secondary buyers and the fund sponsor on behalf of the existing fund. Today, such funds now seem to have gained acceptance as a *bona fide* exit alternative alongside sales to strategic or financial buyers, sales to special purpose acquisition companies ("**SPACs**") or as an alternative to an IPO. Recent examples of such trends include Summa's attempt to move Norwegian biowaste company Norsk Gjenvinning from its debut fund to a separate vehicle, as well as Norvestor SPV II's acquisition of NetNordic Holding AS, the Norway-based provider of broadband and telecommunication solutions for businesses from Norvestor VII LP, the private equity fund of Norvestor Equity AS.

9.2 Are there any particular legal requirements or restrictions impacting their use?

Continuation vehicle transactions raise an issue about the inherent conflict of interest, as both the selling fund and buying fund are often entities controlled by the same GP. This creates governance and process questions that will need to be addressed. Typically, the GP needs approval from its LP Advisory Committee of the existing fund before launching a continuation fund. Since the GP will be on both sides of the transaction, there will be a requirement that the pricing agreed in the transaction is both fair and transparent. Typically, this is carried out by running an auction process or, alternatively, having an independent panel of experts provide a fair market valuation assessment in the form of, *inter alia*, fairness opinions. It should be noted that Norway has implemented the EU Alternative Investment Fund Managers Directive ("**AIFMD**"), and that the Norwegian Act on the Management of Alternative Investment Funds contains, detailed conduct of business rules, including requirements on how the AIFM shall seek to prevent conflicts of interest from arising in connection with the business, as well having in place procedures for the correct and independent valuation of assets of funds. The GP should expect that any GP-led transaction could lead to increased scrutiny from the Norwegian FSA.

10 Tax Matters

10.1 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). However, one may be able to avoid interest deduction limitation for an acquisition vehicle in the year of acquisition for external interest cost, provided the acquisition vehicle is purchased from a pure Norwegian group.

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. The original limitation of related-party interest will exist in parallel with the new "group rule" as a "separate entity rule". Note that the "separate entity rule" also applies to a company within a group not subject to interest limitation due to the escape rules when interest is paid to a related party outside of the group (typically where the related lender is an individual or a company not belonging to the consolidated group for accounting purposes).

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 the International Financial Reporting Standards ("**IFRS**") had been applied in the year prior to the fiscal year in question. In situations where a BidCo is used for an acquisition, one should assume that the group rule will apply for limitation of the BidCo's and its subsidiaries' interest deduction going forward, but possibly avoided in the year of acquisition. Provided the BidCo was exempted from interest limitation, being part of a pure Norwegian group in the prior year or at the time of establishment in the current year, interest limitation according to the group rule should not apply in the year it becomes part of the acquiring fund group and the target group. However, interest limitation according to the separate entity rule may still apply. 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. In order to calculate the effect of the interest limitation rules, one can thus not base this on consolidated accounts. It may thus be beneficial for a group to partly refrain from deduction of interest expenses to avoid exceeding the threshold.

The interest limitation rules applicable to group of companies have two escape rules allowing deduction of interest payments despite the group rule. 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. An effect of the second rule is that a group with Norwegian companies only would not be subject to interest limitation under the group rule. 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 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. Withholding tax applies to payments of interest from 1 July 2021 at a rate of 15%. 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. In short, a country where the effective income taxation of the company's profits is less than two-thirds of the effective taxation that would have been due had the company been resident in Norway, would be considered a low-tax jurisdiction. However, a review of general tax level in the potential low-tax jurisdiction is also required to conclude on the country's status.

Exemptions from withholding tax on interest 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 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-exempt 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 generally accepted accounting principles ("**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 a 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, in 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 and the employer would be obliged to withhold salary taxes from the employee's cash salary.

10.2 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 for at 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. For Norwegian employees, a capital gain made at sale or excise of options granted by the employer would be treated as salary for tax purposes. However, as of 2022, a new rule for taxation of options granted to employees in start-up or growth phase companies has been enforced by the Norwegian Parliament. Subject to various limitations, there shall be no taxation at grant of such options or at exercise, and there will be ordinary capital gain taxation when the shares are sold. This means that any capital gain is taxed at a rate of 37.84% and a loss is deductible, rather than taxable as salary at a marginal rate of 47.4%. Hence, the new rule provides a more beneficial tax treatment than the former tax rules, which simply provided a beneficial timing of income and taxation only. There are also transitional rules that allow options granted under the former regime to be transferred into the new regime. For an employer to grant options under this tax rule, it must be a limited liability company with an average of 50 (or fewer) of full-time employees, and a total account balance of NOK 80 million or less in the income prior to the grant (employees and balances in other group companies inclusive). The company cannot be

older than 10 years, including the year of grant, and detailed rules apply to companies that have been subject to restructurings. Governmental bodies cannot own or vote for 25% or more of the total capital and votes in the company. There are also a number of limitations on which industries the company may be involved in, and the company could not be in financial stress, etc. at the time of granting the options. Further, there are detailed rules on which employees are eligible, e.g. employees must have at least a 25-hour work week and cannot have owned or controlled 5% or more of the capital or votes in the company the last two years. The latter limitation also applies for the group of companies if the employer is part of a group. Finally, there are several limitations on the options to qualify: only shares in the employing company can be acquired; the options cannot be transferred as a gift, by heritage or any other way; the strike price cannot be lower than fair market value of the shares at grant; and vesting time cannot be shorter than three years or longer than 10 years. Finally, there is a limitation on the total value of underlying shares of NOK 60 million at grant and a single employee cannot receive options with an underlying value of NOK 3 million at grant.

10.3 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 the whole or 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 10.1.

10.4 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. Provided that 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. 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 with certain substance in Luxembourg), the WHT exemption should still generally rely on the EEA exemption for corporate shareholders that are not established as wholly artificial arrangements for the purpose of avoiding tax. A review of the current tax status should nevertheless be carried out prior to a distribution of dividends from Norwegian companies.

In addition to introducing interest WHT as described above, WHT on interest and certain rental payments was also introduced and has been 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 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 ("**GAR**"). This was, in many respects, legislation on the previous 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 Norwegian 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.

The most important changes in tax regulations proposed in 2023 include increasing the taxation of income from natural resources, introducing, *i.a.*, ground rate tax for land-based wind power and for the aquaculture industry. The final ground rate tax rate for the aquaculture companies ended at 25% (in addition to ordinary income tax of 22%), effective from 2023. The ground rate tax for land-based wind power has been postponed to 2024.

11 Legal and Regulatory Matters

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

The AIFMD was implemented in 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 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 foregoing 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.

11.2 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.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

From 1 January 2023, the mandatory disclosure and reporting obligations under the Sustainable Finance Disclosure Regulation ("**SFDR**") and the Taxonomy Regulation have been implemented into Norwegian law. These new rules will contribute to standardising ESG disclosures. The SFDR introduces statutory disclosure requirements also for registered alternative fund managers. These rules also introduce certain statutory investment restrictions on alternative investment fund managers, provided they elect to manage or market funds that are so-called Article 8 or 9 funds, meaning funds that promote environmental or social characteristics (light green) and/or funds that have sustainable investment as their objective (dark green).

11.4 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 11.5. 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.

11.5 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 due to regulators generally becoming more aggressive in pursuing the 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).

11.6 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.

12 Other Useful Facts

12.1 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 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 a minimum ownership of the fund.

A transparent fund would, as a starting point, be comprised by a participation exemption independent of its country of residence. If the fund only invests in portfolio companies resident within the EEA only, there are generally no tax issues for Norwegian corporate investors, except for 0.66% taxation on distributions from the fund. However, negative tax consequences for Norwegian investors would occur if the fund invests in portfolio companies in low tax jurisdictions in the EEA or generally outside the EEA. If over 10% of the funds' equity investments are not comprised by the Norwegian participation exemption method at any time in the past two-year period prior to the realisation, a capital gain on interest in the fund itself would not be comprised by tax exemption, hence being subject to Norwegian taxation. However, this 10% rule does not impact the taxation of capital gains that the fund receives and distributes, which would be embraced by a participation exemption, provided the underlying investment is covered by the 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 fund has held at least 10% of the shares and voting power for more than two years at the time of distribution or sale of the shares. 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 fund qualifies for participation exemption.

In a non-transparent fund, the residency of the portfolio company would be of less importance for the taxation of the investors. Returns from such a fund established within the EEA would normally be subject to 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.

In addition to determining the general classification of a foreign fund and its portfolio investments 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 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 and understand whether capital gains would be tax exempted or not in Norway.

Tax treatment of a management fee paid by a PE 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 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.

The possibility of a Norwegian holding company that is not carrying out business activities avoiding reverse charge VAT on services rendered remotely from a foreign service provider, is due to be abolished by amendment of the Act on VAT as from 2023.

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 Norwegian Parliament adopted a bill implementing the Prospectus Regulation into Norwegian law by amending chapter 7 of the STA. In June 2019, the Norwegian Parliament adopted a bill implementing the MAR into Norwegian law; however, 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) need only 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 2023 at the earliest.

Amendments to the disclosure requirements under the STA

As from 1 September 2022, the previous Norwegian rule on mandatory disclosure obligations when the acquisition of warrants and convertible bonds is not linked to any issued (existing) shares issued by a company whose securities are listed on a regulated market has lapsed.

At the same time, the materiality thresholds and disclosure requirements that apply for acquisition of shares in listed companies now also apply for derivatives with shares as an underlying instrument, irrespective of such equity derivatives being cash-settled or settled by physical delivery of the underlying securities (i.e. financially settled options, futures, etc.). It should be noted that for such derivative agreements, the holder must first disclose the conclusion of the derivative agreement itself and then also the acquisition of the underlying shares, if a disclosure limit is still reached or crossed upon such acquisition. The rationale for this is that such financial instruments can be used to make shares unavailable to other players without this becoming known to the market, since the counterparty will often acquire the underlying shares.

The new rules now require the aggregation of holdings of financial instruments linked to the same issuer, so that derivatives must also be aggregated with other holdings. In the case of derivatives with financial settlement, however, only long positions shall be taken into account in the calculation. Long positions (positions that increase in value if the underlying value increases) must therefore not be settled against short positions (positions that decrease in value if the underlying value increases) linked to the same underlying issuer. For instruments that exclusively give the right to financial settlement, the nominal number of the underlying shares must be multiplied by the delta value of the instrument for the purpose of calculating the disclosure obligation. The disclosure obligation must be calculated based on both the investor's share of the share capital and share of the votes, and consequently ownership of non-voting shares could thus indirectly trigger the disclosure obligation. This represents a deviation from the rules as currently set out in the EU Directive (2004/109/EC) adopted by Directive 2013/50/EU, as well as supplementary provisions in Regulation (EU) 2015/761. Still, the right to acquire non-voting shares does not in itself trigger any disclosure obligation.

As from 1 September 2022, both the lenders and borrowers of shares must disclose their position, both at the time of lending and at the time of return, regardless of whether the loan of shares can be classified as a real acquisition of the relevant shares.

The rule under which shares controlled by spouses and children, etc. shall be consolidated when calculating the disclosure threshold has been abolished and, from now, only personal and legal persons who have committed to a long-term common strategy for the exercise of voting rights or who are controlled by the investor according to specific criteria shall be consolidated. Certain other adjustments have also been made to the exceptions from the disclosure obligation/consolidation.

The new disclosure rules also introduce an option for the FSA to decide on the temporary suspension of voting rights in the event of a breach of the disclosure rules as an administrative measure.

Regulatory fees on non-Norwegian AIFMs and UCITS

It should be noted that the Ministry of Finance has now amended the rules governing levy of supervisory fees by the Norwegian regulator so that one-off fees will be levied upon application for authorisation to market AIFs under the national private placement regime, and filing for marketing under the marketing passport of the AIFMD and UCITS Directive. In addition, an ongoing annual fee will be levied for maintenance of the national register of funds registered for marketing.

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 Norwegian 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 2023 at the earliest. However, in April 2020, the Norwegian 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. This temporary regulation has now been prolonged until 1 January 2024.

New EU filing for deals involving parties having received subsidies from third countries

As from 12 January 2023, the EU Foreign Subsidies Regulation ("**FSR**") entered into force. This regulation introduces a filing requirement that is separate from and comes in addition to EU and national merger control/anti-trust filing regimes and will have significant impact on large M&A transactions also going forward in the Norwegian market. The regulation aims to address distortion caused by subsidies from third countries outside the EU to companies or groups of companies operating within the EU and to level the playing field for all companies operating within the EU market.

A transaction will become subject to a filing obligation, when: (i) at least one of the merging entities, acquired companies or joint ventures established in the EU generates turnover exceeding €500 million; and (ii) the entities involved have been granted a combined financial contribution of more than €50 million from third countries outside the EU in the past three years. Only the target's turnover and the buyer's turnover at group level and their combined financial contribution will be relevant. It should be noted that both parties' financial contributions must be included when calculating the combined financial contribution.

The filing obligation is imposed on a buyer and will be triggered by transactions involving a change in control. If a transaction is captured by such notification requirement, it will become subject to a standstill obligation until the transaction has been cleared by the European Commission ("**EC**"). The FSR provides the EC with extensive competence to investigate transactions falling below the thresholds on an *ex officio* basis. The EC may also impose filings in case it suspects that foreign subsidies may have been granted in the three years prior to the transaction.

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TRANSACTIONS POWERED BY EXPERIENCE

Singapore

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?

The most common types of private equity transactions in Singapore are growth capital, venture capital and buyout transactions, minority investments in portfolio companies and exits via trade sales or listings.

Even with a record US$24.5 billion raised by Singapore-based private capital funds in 2022, the volume of private equity deals declined by 10% and the deal value dropped close to 50% compared to 2021. Whilst there was an uptick in exits compared to 2021, the exit value reduced by half. Despite the downturn in deal activity in Southeast Asia, Singapore, together with Indonesia, attracted close to 80% of the total deal value and deal count for the region.

Headline-making deals include Smash Capital, Insight Partners and GIC's US$690 million investment in Coda Payments, SATS' acquisition of Worldwide Flight Services from Cerberus Capital Management for €1.3 billion and SK Ecoplant and Navis Capital Partners' US$1 billion acquisition of TES Envirocorp.

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

Singapore is the most developed market in Southeast Asia, with a stable political-economic environment, robust infrastructure, an investor-friendly tax regime, a transparent and stable regulatory environment and a skilled workforce with a strong pool of professional talent.

The variable capital company structure introduced in 2020 plugs a gap in the Singapore fund ecosystem and gives Singapore a boost as a wealth and fund management hub. It offers investment funds and fund managers significant operational flexibility, less cumbersome capital maintenance requirements (allowing payment of dividends out of capital) and greater tax efficiency. As of October 2022, there were more than 660 variable capital companies domiciled in Singapore. In January 2023, the Monetary Authority of Singapore extended the Variable Capital Companies Grant Scheme for two years. Applicants can seek co-funding for 30% of qualifying expenses paid to Singapore-based service providers for qualifying work performed in Singapore in relation to the incorporation or registration of a variable capital company. This seeks to build on the catalytic effect such grant had on the adoption of the variable capital company structure when the Variable Capital Companies Grant Scheme was first introduced in January 2020.

In 2021, the Singapore Exchange introduced rules allowing for the listing of special purpose acquisition companies (SPACs) on the Mainboard of Singapore Exchange Securities Trading Limited. Since then, three SPACs have listed on the Singapore Exchange. Further, in July 2022, the Singapore Exchange and the New York Stock Exchange agreed to collaborate on the dual listing of companies on both exchanges.

In July 2023, the Monetary Authority of Singapore announced the expansion of its scope of tax incentives for single-family offices through recognising a broader range of investments in Singapore (including overseas climate-related investments) to encourage more purposeful deployment of capital.

These developments provide investors with more choice and opportunities, and make Singapore an attractive gateway to investing in the region.

1.3 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 region has also seen a growing trend of shadow capital investments from large institutional investors (including family offices), sovereign wealth funds and/or pension funds seeking co-investment opportunities with private equity funds. Larger family offices are now making direct investments, particularly in industries where they already have domain expertise and can create value.

The number of family offices in Singapore has grown significantly, with approximately 700 family offices opening in 2022 and another 200 opening in 2023. While the approach taken by each family office differs, they generally have greater speed and flexibility in terms of their strategy, structure and process compared to private equity firms. Family offices may not seek to have a dominant or direct influence on management, they may choose to invest based on non-financial matrices, and they tend to have a longer investment horizon and may not prioritise exits, especially if wealth preservation is the main goal. Further, family offices may not allocate a fixed amount of capital to different asset classes for diversification.

2 Structuring Matters

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

Private equity investments are typically structured with an off-shore holding company whose shares are held by the private equity investor and management. A BidCo is sometimes used under the holding company to hold the target's shares and/or to take on acquisition debt.

2.2 What are the main drivers for these acquisition structures?

The main drivers for these acquisition structures are tax efficiency and financing requirements.

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

Private equity investors typically invest through a combination of ordinary and/or preference equity and convertible debt, with the latter two forming the bulk of the investment.

Key management may be granted equity sweeteners whose structures can vary substantially – from ordinary shares with a vesting schedule, profit participating options exercisable on exit, to subordinated equity.

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

The key considerations when taking minority positions are governance (as specified in section 3 below) and the need to ensure preferred returns. Minority investments by private equity investors usually take the form of convertible or mezzanine debt (to maintain priority) or preferred shares.

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

The typical range of equity allocated to management is 10% to 20%. Management equity typically vests over three to five years, or upon an exit. Management equity is usually subject to (a) "good leaver" and "bad leaver" provisions under which such equity may be acquired at either fair value or at cost, and (b) a drag-along right in the event of an exit by the private equity investor.

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

Persons who leave due to death or disability will usually be treated as good leavers, and persons who are dismissed for causes or in other circumstances justifying summary dismissal will usually be treated as bad leavers.

3 Governance Matters

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

The governance arrangements of private equity portfolio companies with more than one shareholder are usually set out in a shareholder agreement. Typical arrangements include veto rights, restrictions on the transfer of securities, covenants on the continued operation of the business, non-compete undertakings, and deadlock resolution procedures.

Some of the arrangements will also be set out in the portfolio company's constitution, which is made available to the public upon filing with the Accounting and Corporate Regulatory Authority (ACRA). Shareholders' agreements are, however, not required to be filed with ACRA and are generally not required to be made publicly available unless they contain arrangements entered into as part of a take-private transaction governed by the Singapore Takeover Code.

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

Yes, private equity investors typically enjoy veto rights over material corporate actions. Typical veto rights enjoyed by private equity investors include restrictions on further issuances of debt/equity, change of business, winding up and related party transactions. Depending on the size of the minority stake, the private equity investor may also have veto rights over operational matters such as the annual budget and business plan, capital expenditures above a certain threshold and material acquisitions and disposals.

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

Singapore courts will generally enforce veto arrangements at both the shareholder level and the board level. However, veto rights exercised by directors are subject to their overriding fiduciary duty to the company on whose board they sit. Where there is a concern that the directors' ability to exercise their veto rights may be limited by their fiduciary duty owed to the company, such concern is often addressed by giving such veto rights to the shareholders instead of the directors.

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

A private equity investor does not owe any duty to minority shareholders such as management shareholders (or *vice versa*). However, minority shareholders can seek recourse under Section 216 of the Companies Act if the affairs of a Singapore company

are conducted in a manner that is oppressive to one or more minority shareholders. If a finding of oppression is made, the court may order such remedies as it deems fit, including orders regulating the future conduct of the company or a winding up.

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

Singapore courts generally uphold the provisions of a shareholder agreement in relation to a Singapore company, except for those provisions that are unlawful or otherwise regarded as contrary to public policy.

Non-compete and non-solicit provisions are regarded as a restraint on trade and against public policy. These are unenforceable unless the party seeking enforcement can show that the restraint is reasonable and seeks to protect a legitimate proprietary interest.

Provisions that are regarded as penal in nature will also be struck down.

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

Singapore companies require at least one Singapore-resident director. Certain persons (e.g., an undischarged bankrupt or a person who has been convicted for offences relating to fraud or dishonesty) are not eligible to be directors of a Singapore company. Directors of Singapore companies have duties under the Companies Act *vis-à-vis* the Singapore company. These include obligations to disclose their interests in transactions with the company (Section 156 of the Companies Act), an obligation to seek authorisation from the company prior to disclosing information received in their capacity as directors (Section 158 of the Companies Act) and a duty to act honestly at all times and with reasonable diligence in the discharge of its duties (Section 157 of the Companies Act). Such directors also owe a common law fiduciary duty to the company. These obligations apply not only to persons formally appointed as directors of the company, but also to any person whom the court considers a "shadow director" (usually a person whose directions or instructions an appointed director is accustomed to act upon).

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

Directors who face a conflict of interests (whether actual or potential) should disclose the nature of the conflict to the board and abstain from voting on the resolution. Private equity investors should craft their veto rights accordingly so that the investor as a shareholder has the ability to ensure that certain decisions cannot be taken without their consent, even if their directors must abstain from voting.

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?

For public-to-private transactions, the key drivers of the timetable are the mandatory timelines imposed by the Singapore Takeover Code and the clearances required from the Securities Industry Council prior to announcing the transaction. Privatisation transactions subject to the Singapore Takeover Code generally take between two to three months to complete, assuming no other regulatory clearances are required. Where the privatisation is subject to shareholders' approval, the timetable will be stretched by an additional five to seven weeks to include the time needed for clearance by the Singapore Exchange and the notice period for the shareholders' meeting. As public-to-private transactions are subject to certain funds requirements (i.e., the financial adviser or an appropriate third party must be satisfied the offeror has sufficient resources to consummate the offer) prior to launching the transaction, the time needed for the financial adviser or appropriate third party to satisfy this requirement should also be taken into account.

Other factors that may affect the timetable for transactions include the scope of due diligence (including the preparation of financials for the purposes of locked-box structures) and other regulatory approvals. Key regulatory approvals that may materially affect the timeline include industry-specific approvals in relation to holdings in regulated industries (e.g., investments in the banking, insurance, or telecommunications industries) and competition clearances. The timeframe for competition clearance is approximately 30 working days (in respect of a Phase 1 review) and 120 working days (in respect of a Phase 2 review).

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

Transacting parties have been paying more attention to clauses allocating risk arising from matters outside such parties' control. These include material adverse change and *force majeure* clauses dealing specifically with outbreaks of disease (driven by the COVID-19 pandemic) and war (due to the war in Ukraine), and governments' and central banks' reactions to such matters.

With the uncertain economic climate, transacting parties are increasingly looking to incorporate earnouts in their acquisitions to bridge the valuation gaps.

The inclusion of ESG-specific deal terms, such as representations and warranties addressing specific ESG issues, or covenants to ensure compliance with ESG disclosure requirements or to meet ESG targets are also on the rise.

5 Transaction Terms: Public Acquisitions

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

Public-to-private transactions are governed by the Singapore Takeover Code, which imposes certain rules and restrictions that have a significant impact on deal structuring. A firm intention to make a public takeover, once announced, cannot be

subject to, or conditional upon, financing being obtained. The certain funds requirement means that deal financing must be in place at the time of announcement, with limited circumstances under which the financing can be withdrawn.

The Singapore Takeover Code requirement for all shareholders to be treated equally also limits the ability of private equity investors to offer sweeteners to key shareholders, and this often results in higher acquisition costs for public-to-private transactions.

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

Deal protections available to private equity investors in Singapore in relation to public acquisitions include break fees (levied on a target company) and reverse break fees (levied on an offeror). Where a break fee is imposed, the Singapore Takeover Code requires that it be no more than 1% of the value of the offeree company and confirmations must be made by the board of the offeree company and its financial adviser that break fee provisions were agreed upon during ordinary commercial negotiations and it is in the best interests of shareholders; if a break fee has been assessed as a penalty as opposed to a pre-estimate of a loss, it will not be enforceable. While break fees are permitted under the Singapore Takeover Code, they are not commonly used.

Deal protections on the buy-side include no-shop or exclusivity clauses that limit the seller's ability to actively pursue other buyers for a specified period of time. On the sell-side, standstill clauses protect the seller's ability to control the sale process by preventing potential purchasers from acquiring a stake other than via the negotiated deal with the seller.

6 Transaction Terms: Private Acquisitions

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

Private equity investors on the sell-side tend to prefer all cash consideration structures that are subject to adjustments based on completion accounts to be prepared post-completion (typically to adjust for working capital levels). Locked-box structures are sometimes used but are less common.

Buy-side private equity investors also tend to prefer all cash consideration structures, and typically require an escrow amount to be set aside for warranty claims. Earn-out payments or profit guarantees are also preferred mechanisms to bridge valuation gaps.

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

Private equity sellers would typically seek to limit their warranties and/or indemnities to warranties on title, capacity and authority.

Where management holds a significant stake, they are expected to give comprehensive warranties to the buyer, together with a management representation made to the private equity sellers.

Where the management stake is not significant, the private equity sellers may be prepared to increase the scope of warranties subject to limited liability caps of between 10% to 25% of the consideration.

Warranty and indemnity insurance remains a popular way to bridge liability gaps (see question 6.4 below).

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

Private equity sellers typically agree to a set of undertakings as to the conduct of business pre-completion in order to ensure the business is carried on in the ordinary course and to minimise any value leakage. Non-competes or non-solicits are generally not given by the private equity seller, though these would be given by the management team.

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

Warranty and indemnity insurance is popular among private equity investors. It is used on the sell-side to bridge the gap on liability caps and on the buy-side to improve the attractiveness of the private equity investor's bid in competitive bid situations.

Typical excesses range from 0.5% to 1% of the insured amount, and typical policy limits range from 20% to 30% of the insured amount. Customary carve-outs/exclusions include known/disclosed matters, forward-looking warranties, civil or criminal fines, consequential losses, purchase price adjustments, secondary tax liabilities, transfer pricing risks, environmental and anti-bribery/corruption liabilities.

The typical cost of such insurance is around 1.5% of the insured amount.

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

Where the warranties are limited to title, capacity and authority, the private equity seller's liability is either uncapped or capped at the amount of consideration paid. The private equity seller and management team's liabilities for other warranties are usually capped, and the amount of the cap may range from 10% to 100% of the consideration paid, depending on the type of warranty and the strength of each party's bargaining position. Liability under covenants, indemnities and undertakings may not be subject to such caps.

Where known risks are identified, an escrow amount may be set aside from the consideration to satisfy such claims.

General limitations such as time limits within which claims must be made and a *de minimis* threshold before claims can be made are also customary.

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

Generally, private equity sellers do not provide security for warranty claims.

While private equity buyers will try to insist on such security being provided by sellers, the agreement reached between buyer and seller ultimately depends on their respective bargaining strengths.

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

The purchase agreements or bid letters typically include a commitment or warranty from the private equity fund that it has sufficient financial resource to complete the transaction. A bank commitment letter may also be provided in certain cases to provide comfort on the availability of financing where certain funds are required. Such commitments are generally enforceable by the seller against the private equity fund, but bank commitment letters are only intended to provide soft comfort to sellers and are usually not enforceable against the bank.

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

Reverse break fees are not common in Singapore.

7 Transaction Terms: IPOs

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

- Prospectus Liability. A private equity seller participating as a vendor in an IPO is responsible for the accuracy of the prospectus to be issued as part of the public offering of securities under the IPO. Singapore law imposes criminal and civil penalties for false or misleading statements or omissions in the prospectus.
- Prospectus Disclosure. An IPO prospectus is required to disclose all material information, including background information on all vendors (including information relating to their shareholding) in the IPO.
- Lock-ups. A private equity seller may be subject to lock-up requirements under the listing rules of the Singapore Exchange – please see the discussion in question 7.2 below.
- Interested Person Transactions. If the private equity seller retains a shareholding of 15% or more post-listing, it will be an "interested person" for the purposes of the listing rules of the Singapore Exchange and any transactions between the private equity seller (or any of its associates) and the listed company (or any of its subsidiaries or unlisted associated companies) will be "interested person transactions" that will need to be disclosed in the prospectus. Depending on the materiality of the value of the transaction, the listing rules may require announcements to be made and/or prior shareholder approval to be obtained.
- Shareholders' Rights. Generally, the specific contractual rights of private equity shareholders (such as in relation to board appointment and veto rights) are expected to fall away upon listing.
- Underwriting Agreement. The private equity seller will need to enter into an underwriting agreement with the underwriters for the IPO and will need to provide customary representations and warranties (including, potentially, representations and warranties in relation to the listed group) and indemnities.
- Takeovers. The conversion of the portfolio company into a public company will subject its shareholders to the takeover regime under Singapore law, which requires a general offer to be made by any person who, together with its concert parties, either: (a) acquires 30% or more of the voting rights of the company; or (b) holds at least 30% but not more than 50% of the voting rights of the company, and acquires additional shares carrying more than 1% of the voting rights within any six-month period. A private equity seller considering an IPO exit should bear these thresholds in mind when structuring its anticipated level of post-listing shareholding interest.

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

If the private equity seller retains a shareholding of 15% or more at the time of listing, the listing rules of the Singapore Exchange will require a lock-up to be given by the seller over all of their shares for a period of either six or 12 months after listing, depending on the admission criteria upon which the company is listed. If the private equity seller acquired and paid for its shares within a period of 12 months preceding the date of the listing application, the listing rules of the Singapore Exchange will also require a six-month lock-up to be given over a proportion of such shares, the proportion of shares subject to the lock-up reflecting the proportionate price discount enjoyed by the private equity seller in acquiring such shares, compared to the IPO price for the shares.

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

Because they are costly and time/resource consuming, dual-track exit processes are only undertaken when private equity sellers are unsure which option is more likely to be consummated. It follows that private equity sellers are also keen to end dual-track deals as soon as it becomes apparent that consummation of the preferred option is imminent.

Recently, most dual-track deals have been realised through a sale and not an IPO.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (including the syndicated loan market, private credit market and the high-yield bond market).

Traditional bank financing through loans remains the most common source of debt finance for private equity transactions in Singapore. The financing market remains fairly stable and banks continue to show a willingness to support leveraged finance transactions, taking into consideration factors such as the quality of target assets, the track record of the sponsor, the debt quantum, pricing and security package.

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

Leveraged buyouts typically involve a debt pushdown following completion, where the target company takes over the acquisition debt and gives a security package over its assets to the lender.

Such an arrangement constitutes financial assistance on the part of the target company and may need to be whitewashed by its shareholders if it is a public company or a subsidiary of a public company. The prohibition against giving such financial assistance no longer applies to private companies, unless their parent is a public company.

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

In line with continued interest in socially responsible investments, there are more instances of green debt or sustainability financing. Such borrowings may enjoy better rates if they are utilised towards sustainability projects or if the borrower maintains or improves on its environmental, social or governance targets. In view of the impending cessation of the traditional benchmark rates of the currencies relevant for Singapore financings (such as USD LIBOR and SGD Swap Offer Rate), lenders and borrowers continue to actively transition their financings (both existing and new) over to risk-free rates such as USD SOFR and SGD SORA.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

Continuation fund vehicles or GP-led secondary transactions are gaining traction as exit strategies across the sector as the uncertain economic landscape necessitates alternative solutions to provide liquidity.

In early 2023, Capital Square Partners and Basil Technology Partners partnered to close a US$700 million continuation fund, which will acquire a portfolio of companies from both Capital Square Partners and Basil Technology Partners' existing funds under management. This is touted as being a first-of-its-kind deal in Asia.

GIC and NewQuest Capital Partners have also backed a US$267 million continuation fund by Everbridge Partners, a spinout from Capital Group Private Markets.

9.2 Are there any particular legal requirements or restrictions impacting their use?

In a GP-led secondary transaction and the use of continuation fund vehicles, there is an inherent conflict of interest as the entities are controlled by the same general partner. Directors of such entities should be mindful of their fiduciary duty to act in the best interests of the company on whose board they sit rather than a particular stakeholder. Directors who face a conflict of interests (whether actual or potential) should disclose the nature of the conflict to the board and abstain from voting on the resolution.

10 Tax Matters

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

Any income accruing in or derived from Singapore (i.e., sourced in Singapore) or accruing or derived from outside Singapore (i.e., sourced outside Singapore) that is received or deemed received in Singapore, is subject to income tax in Singapore. There is generally no capital gains tax in Singapore, but legislative amendments are being considered to tax gains from the sale of foreign assets that are received in Singapore or deemed as such, where certain conditions are met.

Foreign-sourced income in the form of dividends, branch profits and service income received or deemed to be received in Singapore by a Singapore tax resident company are exempt from tax if certain conditions are met, including: (i) such income is subject to tax of a similar character to income tax under the law of the jurisdiction from which such income is received; and (ii) at the time the income is received in Singapore, the highest rate of tax of a similar character to income tax levied under the law of the territory from which the income is received, on any gains or profits from any trade or business carried on by any company in that territory at that time, is not less than 15%.

All Singapore tax resident companies are under the one-tier corporate tax system. Under this system, the tax on corporate profits is final and dividends paid by a Singapore tax resident company are tax-exempt in the hands of a shareholder (regardless of whether the recipients of such dividends are individuals or corporate entities) and no Singapore withholding tax will be imposed on such dividends.

Where private equity acquisitions are financed (wholly or partly) through debt, any payments in connection with such indebtedness (including but not limited to interest) that are borne by a person or permanent establishment in Singapore and paid to a person not known to be tax resident in Singapore would be subject to withholding tax in Singapore. However, the withholding tax rates may be reduced by tax treaties, and certain exceptions from withholding tax may also be applicable. For instance, a withholding tax exemption may be available for qualifying debt securities where certain conditions are met, and where Singapore financial institutions with the relevant tax incentives have arranged such issuance.

Certain tax incentive schemes may also be available for qualifying Singapore tax resident or non-Singapore tax resident funds that are managed by Singapore-based fund managers. Specified income of qualifying funds derived from a prescribed list of designated investments may be exempt from tax under the fund management incentive schemes. Various conditions must be met by both the fund and the fund manager. However, Singapore will be implementing the Pillar 2 Global Anti-Base Erosion (GloBE) Rules of the Base Erosion and Profit Shifting (BEPS) 2.0 project, and it is unclear whether such implementation will have any impact on these tax incentive schemes.

Off-shore structures are quite commonly used – please see the discussion in question 2.1 above, but off-shore structures utilising the traditional tax haven jurisdictions may come under increased scrutiny and the impending implementation of the OECD's Action Plan on Base Erosion and Profit Shifting may affect the popularity of such off-shore structures.

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

There are no key tax-efficient arrangements for management compensation available in Singapore. Share-based equity plans may be implemented, and awards pursuant to such plans are generally taxable, depending on when they vest (or are exercised, in the case of options) and whether disposal restrictions apply to the shares awarded.

Separately, with respect to any sale of shares, as there is generally no capital gains tax in Singapore (legislative amendments are being considered to tax gains from the sale of foreign assets that are received in Singapore or deemed as such, where certain conditions are met, however), one of the key considerations for private equity transactions is whether the gains from such transactions constitute capital gains or trading income, the latter of which is subject to Singapore income tax. For example, the gains from a sale of shares may be regarded as trading income and subject to income tax if the entity disposing the shares is regarded by the Inland Revenue Authority of Singapore (IRAS) to be trading in such shares or having acquired such shares for subsequent disposal for a profit (as opposed to acquiring such shares for long-term investment holding purposes).

Certain "safe harbour" rules have been enacted in Singapore whereby gains derived by a divesting company from its disposal of ordinary shares in an investee company are not taxable if certain conditions are met. This rule provides that gains derived by a qualifying divesting company from its disposal of ordinary shares in an investee company during the period from 1 June 2012 to 31 December 2027 are not taxable if: (a) the divesting company has legally and beneficially owned at least 20% of the ordinary shares in the investee company for a continuous period of at least 24 months ending on the date immediately prior to the date of the disposal; and (b) the shares disposed of are ordinary shares, and not preference, redeemable or convertible shares. This safe harbour does not apply to: (i) gains or profits from the disposal of shares, which are included as part of the income of an insurer; (ii) an unlisted investee company that is in the business of trading or holding immovable properties, or has undertaken property development, except where (A) the immovable property developed is used by the company to carry on its trade or business (including the business of letting immovable properties), not being a business of trading immovable properties, and (B) the company did not undertake any property development for a period of at least 60 consecutive months before the disposal of shares; and (iii) the disposal of shares by a partnership, limited partnership, or limited liability partnership in which one or more of the partners is a company or companies. This safe harbour rule may be excluded with respect to the proposed new tax to be imposed under the legislative amendments that are being considered, as referred to above.

10.3 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 above, there are no key tax-efficient arrangements for management compensation available in Singapore. Share-based equity plans may be implemented, and awards pursuant to such plans are generally taxable, depending on when they vest (or are exercised, in the case of options) and whether disposal restrictions apply to the shares awarded.

10.4 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?

Additional conveyance duties (ACD) are payable on the acquisition and disposal of certain equity interests in property holding entities that have an interest (directly or indirectly through other entities) in Singapore residential properties (as defined for stamp duty purposes), which meet certain conditions. ACD was introduced to ensure some level of parity of treatment (if certain conditions are met) in the stamp duty to be paid when a person acquires or disposes Singapore residential property directly, *versus* acquiring or disposing the equity interests of the property holding entity that has an interest in the Singapore residential property.

An electronic instrument may be subject to stamp duty no differently from a physical or paper instrument. An electronic instrument refers to:

(a) an electronic record that effects, or an electronic record and a physical document that together effect, the same transaction, whether directly or indirectly, and if the same transaction is effected whether directly or indirectly by a verbal communication and an electronic record, the electronic record, but only if the transaction is concluded by means of the electronic record; and

(b) an electronic record that evidences or signifies a matter (where there is no physical document evidencing or signifying the same).

An electronic record refers to a record generated, communicated, received or stored by electronic means in an information system or for transmission from one information system to another, for example, emails, WhatsApp messages, internet-based messages, etc.

There are specific prescribed rules on, *inter alia*, the circumstances in which, and the place and time at which, an electronic instrument is treated as executed and signed for stamp duty purposes.

Certain stamp duty rates have been increased in Singapore, some quite significantly; therefore, a proper investigation should be made as to the possible stamp duty liability that may be involved prior to making or divesting any direct or indirect investment in Singapore immovable property, especially Singapore residential properties (as defined for stamp duty purposes).

As mentioned earlier, legislative amendments are being considered to tax gains from the sale of foreign assets that are received in Singapore or deemed as such, where certain conditions are met, and Singapore will be implementing the Pillar 2 Global Anti-Base Erosion (GloBE) Rules of the Base Erosion and Profit Shifting (BEPS) 2.0 project.

11 Legal and Regulatory Matters

11.1 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 requirements for voluntary delisting

In 2019, the Singapore Exchange made certain amendments to its listing rules on the requirements for a voluntary delisting by the listed company. These amendments were intended to strengthen minority protection by requiring offerors and their concert parties to abstain from voting on any resolution to approve the voluntary delisting. It also requires the exit offer,

which must accompany the voluntary delisting to be supported by the opinion of an independent financial adviser who must determine that the terms are both fair and reasonable (and not just reasonable, as was the prior requirement). Privatisation via schemes of arrangements will also require a similar opinion. Offers that are not made pursuant to the listing rules are not subject to these requirements but will continue to be subject to the rules and regulations of the Takeover Code.

These changes have tightened the requirements for privatisation transactions and, in particular, for transactions where the private equity investor is in a consortium with the existing major shareholder.

Companies Act amendments to requirements for exercise of compulsory acquisition

With effect from 1 July 2023, amendments were made to the computation of the 90% threshold, which allows an offeror to exercise the compulsory acquisition of shares from non-accepting shareholders. For the purposes of determining whether the offeror has achieved the 90% threshold, the amendments now require the offeror to exclude shares held by an expanded class of persons, including shares held by body corporates in which the offeror is able to exercise 50% or more of the voting power or such other percentage as may be prescribed (whichever is lower). The amendments effectively raise the squeeze-out threshold for offerors by expanding the class of excluded shares.

VCCs

A new corporate structure tailored for investment funds known as the Variable Capital Company (VCC), was introduced in 2020. The new corporate structure provides more operational flexibility to investment fund managers and allows: (i) investment funds to use a single entity to house multiple sub-funds; (ii) dividends to be distributed from capital; and (iii) segregation of the assets and liabilities of the sub-funds. Since the introduction of the regime, more than 400 VCCs have been incorporated in Singapore.

SPACs

SPACs have been allowed to list on the Singapore Exchange since 3 September 2021, and this has given private equity an alternative means to tap capital markets funding. Since the introduction of the regulations, three SPAC listings have been completed on the Singapore Exchange in the first half of 2022.

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

Private equity investors are not subject to enhanced regulatory scrutiny. Generally, only transactions involving regulated industries will be subject to enhanced regulatory approvals – these include, *inter alia*, acquisitions exceeding the prescribed percentage in Singapore incorporated banks, capital markets services licensees, licensed insurers and telecommunications providers. Public-to-private transactions will also need to comply with the regulatory regime under the Singapore Code on Takeovers and Mergers.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

There are currently no additional legal or regulatory requirements specifically relevant to impact investments.

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

Private equity investors typically engage outside counsel to conduct legal due diligence on the target prior to any acquisition. Timeframes for conducting legal due diligence vary, and usually take between one to three months. Such legal due diligence is usually conducted on an "exceptions only" basis, and the materiality and scope will depend on the private equity investor's internal compliance and financing requirements, the complexity of the target's business, and the timeframe for the particular acquisition.

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

Compliance with applicable anti-bribery and anti-corruption laws is a prerequisite to most, if not all private equity transactions in Singapore. If non-compliance is a concern, private equity investors will usually seek to restructure the transaction to isolate the risk (e.g., by acquiring assets instead of shares).

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

Singapore courts would generally not pierce the corporate veil and/or hold a private equity investor liable for the liabilities of underlying portfolio companies or hold one portfolio company liable for the liabilities of another portfolio company in the absence of fraud or bad faith.

12 Other Useful Facts

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

Singapore is an investor-friendly jurisdiction and is consistently ranked as one of the easiest countries in which to do business. In 2023, the Economic Intelligence Unit ranked Singapore as the world's leading business environment for the 15th consecutive year, praising its policy towards foreign investment, foreign trade and exchange controls and technological readiness. Most laws and regulations are in line with international best practices and should be familiar to experienced private equity investors.

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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), ("SpainCap"), the Spanish Private Equity ("PE") industry grew substantially in 2022. In 2021, Spanish PE reached its second-best record of all times in terms of investment volume. In 2022, investment continued to grow, remaining behind only the figures recorded in 2019. Nine hundred and thirty-five transactions were reported, and companies received EUR 8.7 billion in equity, which represents a significant increase compared to 2021 (EUR 7.5 billion). Middle-market transactions (between EUR 10 million and EUR 100 million) also marked a new record high for the fourth year in a row in terms of number of transactions (108) and in terms of investment volume (EUR 2.8 billion), representing an 18% increase over 2021. The increase in large transactions (over EUR 100 million per transaction) where international PE funds have their sweet spot, together with an exceptional investment level in start-ups in mature stages, are some of the main reasons for such improvement. With a total of 15 investments, high-end transactions were significantly relevant, accounting for more than half of the total volume invested. Spanish investors, mainly family offices, also played a relevant role in 2022, with an increase of 15% in terms of investment volume (EUR 1.5 billion, compared to EUR 1.3 billion in 2021) with an increase in transactions from 554 in 2021 to 570 in 2022.

The most active sectors in terms of PE investment in 2022 were IT (24.5%), followed by industrial products and services (14%) and, closely, hospitality/leisure (13%).

In contrast, in 2022 there was a drop in fundraising from domestic private investors, showing a 36% decrease *versus* 2021.

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

Increased visibility of economic recovery in 2022, partly driven by the definitive overcoming of the COVID-19 crisis and the available liquidity, led to a strong reactivation of investments through 2022. Unfortunately, 2022's optimism was corrected based on the new geopolitical framework that began in the first quarter of 2022 and the corresponding effects on inflation and increase in interest rates. Current uncertainty affects PE and all M&A markets across all industries, which may return to a situation in which a special focus will need to be made to portfolio companies, and such uncertainty and high interest rates will most likely reduce the number and volume of PE transactions in 2023. However, the results for 2022 show that the geopolitical environment did not affect the number and volume of transactions ongoing, quite the contrary.

Likewise, following an extraordinary year in 2022, in which confidence in the economic recovery drove to a significant increase in activity, several factors will most probably have an adverse effect on the PE transactional market in 2023: (i) the costs in the investee portfolio have increased significantly in 2022 and are far from being corrected; (ii) penalties will certainly be imposed on valuations because of current general market uncertainty; (iii) PE funds' average waiting times for divestitures will again increase; and (iv) interest rates will increase.

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 will continue to substantially impact 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 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 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 yet representing a consistent trend, 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 style transactions.

Some large industrial companies with liquidity 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 either by financial entities or through vendor loans (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") – the acquiring entities – whose shareholders are the PE funds, jointly with its shareholders and the fund management team, when applicable. A BidCo structure is more commonly used to channel acquisition financing, in part to avoid financial assistance restrictions and to benefit – when financing is needed – from the ability to collateralise target group's shares and assets.

Transaction structures for foreign PE investments focus, in general, on certain tax aspects (mainly the acquisition structure, its financing and 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 countries, considering the wide net 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 Spanish target, which are commonly incorporated in Luxembourg or the Netherlands (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.

In relation to driver (c) mentioned above, special attention is usually paid to minimise the costs arising as a consequence of the acquisition, organising the group existing after the acquisition for the taxation to be as efficient as possible (which usually requires tax consolidation), and taking into account the rules and costs that might apply upon exit.

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

As described above, PE transactions can be executed directly in the target company or channelled through BidCos.

The equity 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).

However, the management team – other than the top manager(s) of the target – is not always required to invest in equity, but is, on many occasions, 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 18–20% 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 (as further explained in questions 2.5 and 2.6 below) 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 structuring unless they entail "control", as such term is defined in the Spanish Competition Laws.

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 where the PE sponsor will have limited control or influence over the management of the portfolio company and probably a reduced market to sell the shares and realise the investment, the negotiation of the shareholders' agreement becomes a key aspect of the transaction. The PE sponsor will usually focus on ensuring that adequate protections of its investment are put in place, such as corporate governance arrangements (e.g., veto rights and/or reinforced majorities for certain matters, a seat at the managing body, etc.), exit provisions (tag-along rights, put options against majority shareholders upon certain milestones, etc.) and key management retention schemes.

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 BidCos 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) and/or, subsidiarily the company, 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 the shares' price is commonly the market price, or it is sometimes allowed that the leaving manager keeps the shares) or bad-leaver situation. Outstanding financing at the moment of exit initially granted to the managers for the acquisition of their stake is commonly compensated with the shares' price and any other compensation that the manager might be entitled to as a result of the exit.

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.

"Bad leaver" situations include, amongst others: (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 a "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 and certain vested rights under the ratchet, if applicable. Bad leavers, however, are usually forced to transfer their shares, which are distributed proportionally amongst the remaining equity holders or by the company.

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 the greater amount between 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 the lower amount between the market value and the 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 managing body of their portfolio companies, even when their representation in such body 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 managing body's 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 managing body's meetings, as well as impose to the company and managers to provide information to shareholders that might not otherwise be entitled by law.

The most common type of managing body is a board of directors. In this regard, the composition of the board is public as the appointment of directors shall be registered at the Mercantile Register. Agreed super-majorities and veto rights are usually reflected in the by-laws and, as such, registered and public. Incorporation in the by-laws and registration grants more certainty on enforceability of such provisions. In any case, shareholders' agreements, which are usually private and confidential documents, also 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. Additionally, shareholders' agreements often contain rules of preference between their provisions and the by-laws, granting priority to the former in cases of contradictions or inaccuracies.

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, veto rights and reinforced majorities are usually negotiated and granted in their favour, generally in respect of increases/reductions of capital, mergers, spin-offs, liquidation, engagement in new activities, relevant acquisition and disposals, capex above a certain threshold, level of indebtedness, related party transactions, approval of the business plan, etc.

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, with the rules of preference mentioned in question 3.1 above.

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 vote 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 with third parties. If the parties want to include this unanimous favourable vote, it is accepted to set a high majority, which only can be achieved if all the members vote in favour.

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 may damage the interest of the company to the benefit of one or more shareholders or third parties. Also, directors shall refrain from voting in respect of resolutions where they may incur in a conflict of interest.

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)?

As mentioned in question 3.3 above, shareholders' 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. It is also common to incorporate them into public deed in order to ensure enforceability between the signing parties.

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 consider 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. Notwithstanding the above, the LSC allows, in certain cases, the general meeting of shareholders to exempt directors from the prohibition to compete with the company or to exempt them from the duty of loyalty for singular and extraordinary situations.

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 general terms, 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).

These restrictions were originally introduced in the framework of the COVID-19 crisis, but with the new Royal Decree 571/2023 of July 4, 2023, the Spanish government has shown its intention to continue with these policies. The new Royal Decree establishes the types of foreign companies and operations that do or do not need to request an investment authorisation from the administration, which improves the predictability of the rule and a series of exemptions to the prior authorisation regime are established. Among other measures, administrative deadlines for foreign investors are also improved and shortened. In this regard, the resolution period is reduced from the current six months to three months. In addition, the possibility of voluntary consultation, binding on the administration and with a response period of 30 working days, is provided for.

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

In recent years, auctions and initial public offerings ("IPOs") have gained 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, and vendors' loans replacing (on occasion) financial entities financing, as well as the use of representations 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 the closing date, and respect the strict, ordinary course of business provisions from the reference date of the financial statements until the 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 and the shares, 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. Management team members do not usually offer representations to the buyer, except for those that might correspond to them as selling shareholders in proportion to their stake.

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. 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 (e.g., four to five years).

Warranties are usually provided for specifically identified potential and relevant 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. As a consequence, the reputational risk of non-performing PE funds is also valued by sellers when considering assuming such risk.

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. Notwithstanding the above, article 42.4 of the Royal Decree 1066/2007 of July 27, 2007 expressly allows a target to grant a break fee to an initial bidder (although not to any subsequent bidder) as compensation for the bidder's expenses in preparation of the offer. The break fee is payable if a competing bid is launched and, as a result, the initial bid does not succeed. In addition, the break fee to be paid by the target is subject to four conditions: (i) its amount must not be greater than 1% of the total value of the bid; (ii) it must be approved by the target's board of directors; (iii) the target's financial adviser must provide a report in favour of the fee; and (iv) it must be disclosed in the offer document.

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 of being 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.

Stock exchange markets' instability and geopolitical environment may have a material impact on the use of dual-track transaction structures in 2023 and beyond as price optimisation may advise those following both tracks.

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 (including the syndicated loan market, private credit market and the high-yield bond market).

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.

Despite the high dependence on financing from traditional banks, the trend for Spanish corporates is to actively source alternative financing. This trend has been reinforced in post-COVID-19 transactions and in the present geopolitical framework, which has raised the rate interests and the finance associated costs.

Regarding syndicated loan structures, rising interest rates have increased their funding costs and the pricing differential between private debt players and banks has narrowed. Private debt funds, which hold loans on their balance sheets, can also close deals faster than banks.

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 10 below).

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

Despite the fact that, in past years, financial entities and banks were offering high liquidity and lower interest rates in the Spanish market, driven by a macroeconomic positive environment and a record of PE transactions, a significant increase in direct lending from funds has been observed. Thus, both bank financing and direct lending have co-existed providing investors and companies with a diversified menu of debt structures. Nevertheless, the perceived increasing economic uncertainty (e.g., rising inflation, the economic effects of the Ukraine war, rising interest rates and the associated regulatory developments intending to mitigate them) slowed down debt-financing activity during the last quarter of 2022.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

The PE secondary market has grown and become significantly sophisticated. The use of continuation fund vehicles aims, on the one hand, to provide liquidity to existing investors and, on the other hand, to extend the holding period of assets, which, with more time and capital, can generate attractive additional returns. The rise and growth of the secondary market is also explained by its flexible liquidity solutions that allow for the renewal or replacement of part of the investor base.

In this regard, it is expected that over the next few years that the presence of this type of transaction will increase due to the advantages it brings to certain PE investors. In any case, the future evolution and consolidation of the secondary market in Spain will depend, to a large extent, on the ability of portfolio companies to maintain growth.

9.2 Are there any particular legal requirements or restrictions impacting their use?

At a Spanish level, for the time being, there are no different restrictions or legal requirements defined for this type of transaction (beyond the regulations explained above applicable to all PE transactions). However, this is an issue that may change in the coming years, as in jurisdictions such as the U.S., where the Securities Exchange Commission ("SEC") has already expressed its willingness to focus on this type of transactions and regulate certain matters associated with them.

10 Tax Matters

10.1 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 analysis 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 option for 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 95%-exempt from Corporate Income Tax ("CIT"). Likewise, capital gains obtained by Spanish entities from the transfer of Spanish subsidiaries are also entitled to the 95% exemption to the extent that certain requirements are met.

The standard CIT rate is 25%, so the 95% participation exemption leads to an effective 1.25% (25% × 5%) taxation on qualifying dividends and capital gains.

10.2 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 over more than two years); or (iii) stock appreciation or similar rights ("SAR").

If 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 28% Personal Income Tax general 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).

Starting to apply on January 1, 2023, new personal income tax rules have been introduced regulating taxation of the on carried interest. Previously, only the territories of the Basque Country and Navarra had rules on this topic.

The new rules apply to income obtained from the successful management of PE entities: (a) closed-ended alternative investment funds, as defined in Directive 2011/61/EU, falling into any of the following categories (i) PE entities as defined in article 3 of Law 22/2014 of November 12, 2014, (ii) European venture capital funds, (iii) European social entrepreneurship funds, and (iv) European long-term investment funds; and (b) other similar investment schemes to those mentioned.

The specific provisions are as follows: (a) carried interest is defined expressly in the law as salary income; (b) a 50% portion of this income will be included without applying any exemption or reduction whatsoever, provided the following requirements are fulfilled (i) the economic rights will have to be conditional on the other investors at the entity obtaining a minimum level of profitability defined in the entity's regulations or bylaws, and (ii) the shares or rights must be held for at least five years, unless a transfer following death occurs, or they are liquidated earlier or become null and void due to a change of management entity.

This last requirement will be laid down, as applicable, for the entities owning the shares or rights.

This tax treatment will not be applicable where the special economic rights come directly or indirectly from an entity resident in a country or territory considered as a non-cooperative jurisdiction or with which there is legislation on mutual assistance regarding the exchange of tax information.

10.3 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 10.2 above, capital gains at exit are generally subject to Personal Income Tax at a 28% maximum marginal tax rate (depending on the Autonomous Community).

The main tax consideration in the reinvestment of part of the management team's investment into a new acquisition structure is that the exchange of shares 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 (e.g., when "coexisting" an exchange of shares and a transfer of shares, under certain conditions). 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.

10.4 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 effect as of January 1, 2015 (mainly due to the amendments on interest deductibility – specific limits for LBO transactions – and tax consolidation). As explained in question 10.2 above, Spain has enacted certain regulations on carried interest (previously, only the territories of the Basque Country and Navarra had specific regulations on this topic). In 2020, a 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 structures has been the main area of discussion over the last few years (especially in intra-group indebtedness), together with the remuneration of the management team (see question 10.2 above) and 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 types of hybrid situations and hybrid mismatches.

Tax rulings aimed at providing legal security to 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.

11 Legal and Regulatory Matters

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

The regulatory framework for PE investors has remained stable since the Spanish Law 22/2014 on regulated PE vehicles and close-ended collective investment (the "PE Law") transposed the AIFM directive for Spanish PE vehicles. Since then, the PE Law has granted a stable regulatory framework for PE vehicles.

11.2 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.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

Impact investments are not subject to any additional requirements 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.

11.4 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, 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.

11.5 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 houses have one or more compliance-dedicated officers taking care, among other tasks, of conducting (at least) certain preliminary due diligence when approaching a potential investment. Additionally, certain compliance provisions and covenants are usually seen in investment and/or shareholders' agreements.

11.6 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.

12 Other Useful Facts

12.1 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 legal and tax 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. After 2021 being a record deal-making year for private equity, activity in 2022 returned to more regular levels and the total deal value dropped due to the absence of any large-scale transactions (according to the KPMG M&A Sector Reports for Switzerland in 2022).

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

M&A activity in Switzerland decreased in early 2023, likely due to inflation and therefore higher interest rates for transaction financing. It is further possible that the shock of the downfall of Credit Suisse is still causing hesitation among deal makers to initiate new projects.

1.3 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, the 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" or "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 above regarding stock corporations apply largely also to LLCs.

On 1 January 2023, Switzerland saw a general corporate law reform enter into force. The aim of the reform was 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 facilitates company formation, makes capital rules more flexible (e.g. allows for capital to be denominated in certain foreign currencies) and partially amends the rules on corporate restructurings.

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. While a general regime on foreign direct investments is currently in discussion, it is not yet clear if any of the proposed rules will be adopted.

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?

With a clear sellers' market, the recent trend of share purchase agreements tending to be more seller-friendly (e.g. with regard to representations and warranties ("R&W"), warranty and indemnity ("W&I") insurances, no CPs, etc.), is gradually shifting back to more balanced terms.

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 a public tender 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) 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 (although disclosure obligations must be complied with). 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 R&W 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 that 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 of six to 18 months after the initial public offering ("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 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 and obligations regarding transparency on non-financial matters such as ESG). 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?

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 typically be required by the underwriters to sign lock-up undertakings of 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 (including the syndicated loan market, private credit market and the high-yield bond market).

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. 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 due to Swiss corporate law restrictions. 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 with respect to related-party debt. Additionally, interest paid on amounts of debt provided by shareholders 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% dividend withholding tax. 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).

In order to avoid interest withholding tax of 35%, financing of a Swiss acquisition company must comply with the so-called 10/20 non-bank rules. While interest paid on loans is generally not subject to Swiss withholding tax, withholding tax applies to interest payments on bonds (at a rate of 35%). According to guidelines of the Swiss tax authorities, a loan is considered

a bond if either the aggregate number of non-bank lenders (including sub-participations) exceeds 10 under financing arrangements with identical terms, or if the aggregate number of non-bank lenders of a Swiss borrower exceeds 20. Against this background, transfer restrictions and other Swiss 10/20 non-bank rules-related language must be incorporated into the relevant loan document.

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

M&A activities remain a major driver for debt-financing transactions. However, the debt-financing market is also impacted by the following trends:

- competition on the lending market between traditional bank and syndicated lending, and non-bank lenders showing an appetite for higher leverage;
- a growing interest for ESG-related financing; and
- a hike in interest rates.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

Because private equity funds are typically not structured as Swiss collective investment schemes, these types of transactions are not seen in Switzerland as a fund jurisdiction. However, GP-led secondaries and stapled transactions are also extended to Swiss investors from time to time.

9.2 Are there any particular legal requirements or restrictions impacting their use?

See above. Where Swiss investors are targeted in GP-led secondary transactions, the Swiss fund marketing regime may need to be considered (*cf.* also section 11 below).

10 Tax Matters

10.1 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 such as Cayman Islands, Guernsey, Jersey, Luxembourg or Scotland, but also Germany, Liechtenstein or the Netherlands.

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.

For financing considerations, see question 8.2. above.

10.2 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)?

From a Swiss tax point of view, "genuine" employee shares (i.e. participation instruments that qualify for dividend rights and liquidation proceeds) are generally more favourable, compared to instruments, which qualify as "non-genuine" employee participations (such as synthetic bonus schemes, phantom shares that are taxed upon realisation/exercise). Options for shares are taxed upon exercise or sale. The acquisition of shares at fair market value ("FMV") does not lead to taxable income. A capital gain on the sale of shares that have been acquired at 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 a fall-back, a formula value can be applied as approximate for the FMV. The formula value, once chosen, must generally be applied for the entire duration of the employee share incentive plan. There are no specific tax reliefs or tax provisions for management share participations if shares are acquired below FMV (formula value), 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%). The taxable income at acquisition 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). A capital gain on the sale of shares that have been acquired at formula value by a Swiss resident manager more than five years ago will generally qualify for a tax exemption. A sale before the expiration of the blocking period may result in a taxable salary in the amount of the remaining blocking period discount applied at the FMV (formula value) at that time.

10.3 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).

10.4 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 important. 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. A recent anti-abuse practice may result in non-refundable Swiss withholding tax on dividends by the Swiss target in cases where the Swiss acquisition company is held by a fund/non-treaty shareholder and is financed with intercompany debt/capital contribution reserves, which can be repaid without withholding tax (so called "extended international transposition"). Economic reasons for the Swiss acquisition company may help and should be confirmed in an advance tax ruling.

Further, Swiss tax authorities tend to scrutinise tax-exempt capital gains for selling managers, in particular within five years (see question 10.2. above). Also, purchase price components or transaction *boni* may result in taxable salary (and social security charges for the Swiss target). 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 also note 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.

11 Legal and Regulatory Matters

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

The Swiss corporate law reform (see question 3.1 above) entered into force in January 2023. This also includes provisions on excessive compensation for listed companies, which already existed at the level of a separate ordinance and have been moved into the Swiss Code of Obligations.

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. The amended rules also brought about a *de facto* abolition of bearer shares.

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 revised regime was initially subject to transitional rules of up to two years, meaning that the new laws have, with few exceptions, become fully effective at the beginning of 2022. The FinSA introduced new concepts of financial services regulation, partly modelled on MiFID, to Switzerland. In this context, the Collective Investment Schemes Act ("CISA") was also revised, affecting among other aspects the regulatory framework for the marketing and offering of interests in private equity funds and other investment funds in or into Switzerland.

Compared with the old law, the FinSA/CISA regime is more closely integrated with general financial instruments regulations and enables the offering of foreign investment funds, including private equity 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 Financial Market Supervisory Authority ("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" under the FinSA and may trigger specific point-of-sale duties and other regulatory requirements, even if conducted on a cross-border basis from abroad into Switzerland.

In December 2021, the Swiss parliament adopted another revision of the CISA, by which a new fund category, the so-called Limited Qualified Investor Fund ("L-QIF") will be introduced in Switzerland. The L-QIF will be exempt from the requirement to obtain authorisation and approval from FINMA and will not have any specific limitations regarding the investment universe and risk diversification. As such, the L-QIF will be broadly comparable to similar unregulated fund categories in known fund jurisdictions. This should increase Switzerland's competitiveness as a fund location in the future. The bill is expected to come into force in late 2023 or early 2024.

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

Switzerland does not have any generally applicable restrictions, notification duties or approval requirements in place with regard to foreign direct investments ("FDI"). As mentioned in question 4.1 above, an FDI regime is currently in discussion. Specific restrictions exist for companies that are publicly owned (at federal, cantonal or municipal level), such as in telecommunications, radio and TV broadcasting, defence, nuclear energy and aviation. Furthermore, sector-specific restrictions apply regarding foreign control over Swiss regulated entities, such as banks or securities firms.

The preliminary draft of the Investment Control Act was published on 18 May 2022 and provides for a notification and approval requirement for certain acquisitions of domestic companies by foreign investors. It distinguishes between state-owned or state-related and private foreign investors. For both investor groups, *de minimis* thresholds apply, below which the transaction does not have to be notified. The preliminary draft further provides for sanctions that can be as high as 10% of the transaction value, among others. Due to mostly negative reviews of the preliminary draft, the Federal Council ordered the Federal Department of Economic Affairs, Education and Research on 10 May 2023 to draw up a draft bill until the end of 2023, with a more limited scope. Such bill should only apply to acquisitions of domestic businesses in critical infrastructures such as defence equipment, electricity transmission and production, or health and telecoms infrastructures by state-owned foreign investors.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

In its strategic goals for the years 2021–2024, FINMA committed to contributing to the sustainable development of

the Swiss financial centre. The focus of FINMA is primarily on the sustainability-related financial risks for financial institutions and the financial system. Currently, FINMA considers climate-related financial risks as the most measurable and significant financial risks in connection with sustainability. In addition, FINMA focuses in particular on the client protection issue of greenwashing in the distribution of financial products and services. Clients may not be deceived by exaggerated or misleading claims about sustainable attributes, e.g. of investment products.

11.4 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.

11.5 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.

11.6 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 above).

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 12 below.

Under normal circumstances, it is highly unlikely that a portfolio company will be liable for another portfolio company.

12 Other Useful Facts

12.1 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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Bär & Karrer is a leading Swiss law firm with more than 200 lawyers in Zurich, Geneva, Lugano, Zug and Basel. 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.

- 2023 *Citywealth* IFC Awards ("Law Firm of the Year – Switzerland").
- 2022 *Mergermarket* European M&A Awards ("Switzerland Legal Advisor of the Year").
- 2022 Women in Business Law Awards EMEA ("Switzerland Firm of the Year" and "Gender Diversity International Firm of the Year").
- 2022 International Legal Alliance Summit & Awards ("Law Firm of the Year – Switzerland").
- 2022 Legal Community Awards Switzerland ("Law Firm of the Year" (general), "Law Firm of the Year – Corporate and M&A", and "Law Firm of the Year – Sustainability").
- 2021 *IFLR* European Awards ("Debt and Equity-linked Deal of the Year" for the Novartis Sustainability-Linked Bonds Deal).
- 2021 *Who's Who Legal* ("Law Firm of the Year" in Litigation, Private Clients and Sports).
- 2020 IP Global Awards ("Swiss IP-Transactions Firm of the Year").
- 2020, 2019, 2018, 2017 and 2016 Trophées du Droit Gold or Silver.
- 2019 STEP Awards ("International Legal Team of the Year").
- 2019 *Citywealth* Magic Circle Awards ("Law Firm of the Year – Switzerland").
- 2019 *IFLR* Awards ("Debt and Equity-linked Deal of the Year").
- 2019, 2015 and 2014 *IFLR* Awards ("Legal Adviser of the Year – Switzerland").
- 2019, 2018, 2016, 2015 and 2014 *Mergermarket* M&A Awards.
- 2018 *IFLR* Awards ("Deal of the Year").
- 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?

The most common types of private equity ("PE") transactions in the UK are leveraged buyouts (predominantly in the form of a share sale, but they may also take the form of asset acquisitions). Additional types of PE transactions include take-private transactions, flotations and bolt-on transactions. Accompanying the majority of these transactions will also be the leveraged financing/refinancing of such deals from a variety of debt sources.

A notable trend in the PE market between 2020 and 2022 (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 and the perceived relative value of public listed targets. 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. Further trends have included a larger than usual amount of club deals, with a number of PE firms forming clubs to acquire larger assets.

However, 2023 to date has marked a relative slowdown in PE M&A activity compared with previous years, reflecting (amongst other things) the high levels of inflation in the market and reducing revenues in many businesses.

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.

As dealmaking returned following the severe start to the COVID-19 pandemic, the large amounts of dry powder (raised funds) and declining value of GBP *vs* USD led to a surge in activity in recent years. As discussed above, activity has slowed due to, amongst other issues, high levels of inflation; this has not been an issue exclusive to the UK market.

1.3 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, greater returns, 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 unused 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, which is payable (usually) by a buyer at 0.5% on the future transfer or sale of shares in a UK company.

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, in some cases, (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 the top holding entity in the structure ("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 or preferred equity, often in the form of "payment in kind" ("PIK") loan notes or preference shares, which carry a right to annual interest or coupon. The combination of ordinary share capital and preference shares/shareholder debt held by the PE investor is commonly referred to as the "institutional strip".

Management will commonly also take an equity stake 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.

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

The drivers described in question 2.2 above 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 and *vice versa*.

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 their acquisition cost and, subject to vesting provisions, fair market value at the point of sale 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 vetoes 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 vetoes.

Vetoes 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") and the UK Data Protection Act 2018 and UK GDPR, which govern the transmission and collection of data in the European Union and the UK, can add further challenges to older shareholders' agreements, which may find their existing provisions (e.g. in relation to information) ceasing to be compliant with new regulations.

Non-compete and non-solicit provisions need to be aimed at providing reasonable protection for the relevant goodwill (i.e. the investment of the PE sponsor in the company), for a reasonable period, and within a reasonable area in order to be effective under English law. As a basic position, English law dislikes covenants 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 above), 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 (including, in particular, EU competition filings and U.S. CFIUS 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 over 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.

During the spike in deal activity following the COVID-19 pandemic, auction processes demonstrated 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 and bidders being less aggressive in their deal asks. This trend has been less prevalent in recent months as deal activity levels have fallen.

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

In recent months, the UK PE M&A landscape has switched from being generally favourable to sellers (both PE and non-PE) to favouring buyers. Due to a variety of reasons, including lower revenues in target businesses, high inflation and relatively expensive lending rates, PE buyers have not been willing to pay prices that are palatable to sellers. Sellers in turn appear to be holding onto assets where they can, waiting for a more favourable market.

It appears that many PE firms still have cash ready to deploy on transactions at the correct price.

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) requirements around the certainty of funding for such transactions and 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. 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.

"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.

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.

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 initial public offering ("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 or that the value that may be realised following the end of any applicable lock-up periods will be the same as the valuation of the investee company at the point of IPO. 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?

Given current market volatility (due to the war in Ukraine and other geopolitical, financial and supply chain issues), continued high inflation, and rising interest rates, 2023 has seen fewer PE exits than 2021 and 2022. In light of current economic challenges and the effect of these challenges on public markets more generally, PE sponsors are generally not exploring dual-track exit routes, with a greater number of deals being 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 an IPO exit (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 (including the syndicated loan market, private credit market and the high-yield bond market).

Historically, bank-led leveraged loan financings were the most common source of debt finance used to fund both mid-market and large PE transactions in the UK.

However, in recent years, private credit funds have become a mainstay funding solution for a significant share of the market, with unitranche financing structures becoming commonplace. Other debt instruments, such as holdco PIK remains a relatively small portion of the overall financing provided by private credit funds.

For larger PE transactions, leveraged loans are often structured as a term loan B (or "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 (albeit the TLB market has been adversely affected by the downturn over the last 12 months). For larger PE transactions too though, increasingly private credit funds are becoming a "go to" source of financing, sometimes with such funds now clubbing together to form a syndicate to provide a funding solution to some of the larger transactions.

Aside from leveraged loan financing, high-yield bond financing is an important source of funds and is commonly (albeit subject to fluctuating availability in the market) used alongside traditional senior secured bank loans although, as with the TLB market, dislocation this year has muted issuance significantly.

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 or private credit solution compared with 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, general competition and specific national security interest law issues. 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 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?

With the dislocation in the high-yield market, the impact of rising inflation, quantitative tightening, increasing interest rates and supply chain issues coupled with increased energy prices and the geo-political issues that have arisen around the world, this has had a significant impact on PE deal flow generally; however, in this context, private credit as a funding solution has become even more important for PE transactions given the committed nature of the capital available, its continued availability at scale and the flexibility of the product with generally sole counterparty execution risk. This source of financing has been seen to fill the void in a number of instances to what would otherwise have been a high-yield or TLB solution, as well as having become a main stay of funding for the PE mid-market.

For those transactions being closed in the current environment, leverage levels have been reduced, day one equity cheques from PE sponsors have increased (as an overall percentage of the capital structure) and documentary terms and structures for lenders have improved. There has been a period of lender pushback in light of the tightened liquidity conditions, particularly in limiting add backs to EBITDA in relation to synergies and group initiatives.

Also, the custom of the borrower "designating" the lender counsel, which had become prevalent in the mid and upper mid markets, has seen some strong pushback from lenders following some high-profile fallouts over the practice. It remains to be seen if this trend will continue in more buoyant market conditions.

ESG requirements have also become a feature of the market, with more loans having ESG ratchet triggers contained within them, which is a feature being driven by some of the investors investing into private credit funds.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

Outside of the US, the UK is the largest market in the world for GP-led liquidity solutions. The most significant portion of these solutions is the use of continuation fund vehicles, namely GP-led secondaries. These transactions have become a well-accepted form of exit for fund managers seeking an alternative to an M&A sale or a public offering. In many cases, GP-led secondary transactions are conducted along lines not dissimilar to an M&A sale process, such as running a competitive auction to solicit multiple bids, the use of a financial advisor to run the process and the documentation underlying the transaction (e.g. a sale and purchase agreement, the use of representation and warranty insurance and the use of fairness opinions).

9.2 Are there any particular legal requirements or restrictions impacting their use?

Continuation fund vehicles, depending on the exact nature of the transaction at hand may be "alternative investment funds" ("AIFs") within the meaning of the AIFMD or they may not. If they are AIFs, the GP will need to comply with the applicable provisions of the AIFMD. In addition, the GP itself will need to comply with laws and regulations applying to it as the alternative investment fund manager. Although not law or regulation, many GPs will have regard to the guidance issued by the

Institutional Limited Partners Association ("ILPA") on GP-led secondaries as a matter of best industry practice. ILPA has, this year, issued guidance on GP-led secondaries transactions, updating its previous guidance from 2019. Lastly, the use of continuation vehicles in GP-led secondaries is impacted by a tax analysis of whether the transaction terms produce tax-neutral or tax-favourable outcomes for existing investors who choose to participate in the continuation fund.

10 Tax Matters

10.1 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), 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 10.2 and 10.3 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.

10.2 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. The availability of favourable tax treatment for carried interest remains controversial politically and the chief opposition party, the Labour Party, has committed to abolish it should it come to power.

For equity investment/co-investment, senior management may be able to claim business asset disposal 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. Since 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. However, growth shares can present relatively complex valuation issues.

10.3 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 above). 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 sought from HM Revenue & Customs ("HMRC") in connection with any tax-neutral rollover and should be factored into the transaction timing.

10.4 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?

From a fund perspective, the recent introduction of the Qualified Asset Holding Company ("QAHC"), a UK tax advantaged asset holding company, potentially offers an attractive vehicle through which PE funds can hold assets onshore. For certain types of assets, where the qualifying conditions can be satisfied, we are likely to see an increased movement to the use of UK QAHCs over more traditional Luxembourg asset-holding structures.

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"), which overlays the application of the UK's tax treaties with other participating jurisdictions. This has led to the increasing need for "substance" in entities seeking treaty benefits.

On an international level, 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. ATAD III (the anti-shell directive) remains in the pipeline (potentially effective 1 January 2024) and will impact on PE structures using so called "shell entities". Following Brexit, the UK has now stepped away from the mandatory disclosure rules introduced in Europe ("DAC6") and has introduced new rules ("MDR") that are intended to align with the OECD's Mandatory Disclosure Rules.

11 Legal and Regulatory Matters

11.1 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, 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.

11.2 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 National Security and Investment Act, which covers investments made by UK or non-UK investors in targets having a presence in the UK through 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.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

Impact investments are not generally subject to additional legal or regulatory scrutiny, though may require enhanced approval procedures and reporting to investors depending on the framework agreed with the investors in the particular fund. In addition, sponsors may choose to comply with certain "best practice" recommendations and certifications (such as obtaining B-Corp status), which may create ongoing compliance and reporting requirements.

11.4 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.

11.5 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.

11.6 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).

12 Other Useful Facts

12.1 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 certainty and clarity offered by English law and regulation means that 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 exits in the UK continued in line with transaction volumes seen in other jurisdictions over 2021–2023 (with some slowdown over H2 2022 and H1 2023 due to prevailing market and macro-economic conditions) and the UK's legal divergence from the European Union has proven gradual.

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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 during the first half of 2023 continued to slow following the surges during 2021 and the early part of 2022. While PE firms continue to have significant levels of dry powder at their disposal, the war in Ukraine, geopolitical tensions with China, regional banking system collapses, stress in the commercial office lease market, inflation and rising interest rate levels have created a more challenging environment for M&A and injected uncertainty into the outlook for the remainder of 2023. Fundraising activity slowed meaningfully in the first half of 2023, with many investors' portfolios already overallocated to the private markets – a direct result of the declines in the value of public stocks. In addition, risk-averse lenders have made access to debt financing difficult; and with the slowdown in PE exit activity and a lack of GP distributions, LPs have been left with less capital with which to invest in new funds. The foregoing, coupled with a limited number of high-quality assets available in the market, has made the current landscape for PE challenging.

The frothy, competitive deal environment that characterized the past several years prior to the current slowdown resulted in 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. We have also seen more acquisitions of founder-owned private companies than any prior year. The changing landscape in 2023 is slowing traditional PE investing and is expected to increase hold periods, but opportunities remain for portfolio company add-ons, take-privates, co-investments and opportunistic transactions, and continuation funds and GP-led secondaries continue to attract attention. Additionally, some funds may be well-positioned to take advantage of opportunities in the current market.

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

During 2021 and the early part of 2022, M&A activity was characterized by extremely competitive auctions, which resulted in historically high selling multiples, seller-favorable terms and intense pressure on certainty and speed to closing. While dry powder is still near record levels, parties are now faced with a less attractive environment for deal-making, with high inflation, rising interest rates and bank/financial institution uncertainty increasing the cost of borrowing, which in turn is pushing down valuations and increasing the proportion of equity-to-debt for many new deals. The continued war in Ukraine, supply chain disruptions in certain industries and persistent labor shortages have also had an impact. These factors have been shifting the market away from the seller-favorable terms that dominated the last several years, and that trend is expected to continue in the near term.

The regulatory environment continues to become more challenging for PE transactions. The U.S. Federal Trade Commission ("FTC") and Department of Justice ("DOJ") have increased the level of scrutiny applied to acquisitions by PE firms. 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. In addition, the U.S. government is considering measures to review outbound investments for potential U.S. national security concerns, though the scope and timing for implementation of such measures remain unclear.

1.3 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 these funds are outperforming in fundraising and may be better positioned to take advantage of opportunities 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.

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; however, in recent years there has been an 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 10. 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. Third-party contract consents may be required, and acquired assets may be entangled with seller assets that are outside the scope of the transaction. For certain regulated businesses, permits and licenses may need to be transferred or reissued. 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 returns on equity investments and management fees. Equity structuring varies depending on the PE sponsor involved, the portfolio company risk profile and the IRR sought. Equity most often consists of preferred and/or common equity interests held by the PE sponsor. Often, some or each type of equity is offered to existing, or "rollover," target investors. Preferred equity can be used to set minimum returns and incentivize common or other junior security holders to drive portfolio company performance. PE funds often offer portfolio company management equity-based incentive compensation in the form of stock options, restricted stock, phantom or other synthetic equity or profits interests, each of which is subject to vesting requirements. Carried interest is typically found at the fund level and does 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. Minority protection rights may 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 protections such as board and committee representation, information and inspection rights, tag-along rights, limitations on drag-along rights of the controlling party, 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, which in some instances is subject to minimum return hurdles. 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 common.

Compulsory repurchase provisions (i.e., "put" rights) are not typical, but portfolio companies customarily reserve the right to repurchase an employee's equity in connection with the employee's termination at either 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 typical 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, their employment terminates due to death or disability or upon normal retirement.

Bad leavers are commonly those who are terminated for cause and, in some cases, those who 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 level in the portfolio company's ownership structure where management investors will hold their equity interests post-acquisition. For control investments, PE sponsors will often control the manager and/or the board of the buyer, any parent companies above the buyer entity, 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) tag-along and drag-along rights; (iii) pre-emptive rights; (iv) rights to elect the manager or board of directors; (v) information rights; (vi) special rights with respect to management equity, including repurchase rights; and (vii) limits on certain fiduciary and other duties to the extent permitted by state law. For larger portfolio companies contemplating exits through initial public offerings ("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.

Beginning in 2024, the Corporate Transparency Act will require most U.S. companies (subject to certain exceptions) to begin reporting to FinCEN certain information about their beneficial owners (defined as any individual who directly or indirectly exercises substantial control over or owns or controls at least 25% of the company) and the individual who files the document forming or registering the company. Companies and their advisors should begin to prepare for the new reporting requirements now in order to avoid any potential delays in entity formation and reporting next year.

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 right 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 in the form of contractual rights in favor of specified shareholders or classes of equity contained in an organization's governing documents (i.e., shareholders' agreement, LLC agreement or LP 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*. 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 3.4.

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 the corporate conduct in question (even if the controller owns less than 50% of the equity) is 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, the primary fiduciary duties owed by a controlling shareholder (and the board of directors) to shareholders are the duties of care and loyalty (along with ancillary duties, such as those arising under the corporate opportunity doctrine). The duty of care requires directors to make informed and deliberate business decisions. The duty of loyalty requires that decisions be made in the best interests of the company and its shareholders (and not based on personal interests or self-dealing).

Under Delaware law, corporate entities can (and usually do) exculpate breaches of the duty of care; but the duty of loyalty cannot be waived in corporate organizational documents. However, the Delaware Court of Chancery recently held that shareholders can contractually waive the duty of loyalty under certain conditions concerning the sophistication of the shareholders and their ability to negotiate the waiver, the reasonableness and application of the waiver, and the clarity of the waiver language.

By contrast with the corporate statute, the Delaware statutes for alternative entities like LLCs and LPs allow the parties to broadly waive the duty of loyalty. For this reason, among others, PE sponsors frequently organize their investment vehicles as LLCs or LPs in Delaware and include in the LLC or LP agreement an express waiver of fiduciary duties owed to minority investors. Absent an express waiver, however, courts will apply traditional corporate-like fiduciary duties to the board and the controller's conduct. 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 the

portfolio company (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 a limited liability company or limited partnership and its members or partners, as applicable, provide greater flexibility than shareholders' agreements, which are contracts that are typically among a corporation and its shareholders. 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, which varies significantly by jurisdiction and continues to evolve, and must be evaluated on a case-by-case basis. At a minimum, such covenants must protect the legitimate business interests of the company and be reasonable with respect to duration, geographic reach, and scope of restricted activities. 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, may be subject to public policy limitations in certain jurisdictions.

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 who nominate 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. In 2022, DOJ officials said they were "ramping up efforts" to identify interlocking director violations and "committed to taking aggressive action" against PE investments in competitors that lead to interlocking boards. DOJ enforcement actions in 2022 and 2023 resulted in resignations of board members who were designees of PE firms, including Apollo and Thoma Bravo.

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 enacted 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. Furthermore, while the fiduciary duties to the company remain the same, the ultimate stakeholders may change in certain jurisdictions 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 3.4. 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, if applicable.

Antitrust clearance is the most common regulatory clearance faced. Only persons and entities 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 (2023: US$111.4 million). In most transactions, the HSR filing is submitted after the parties have signed a definitive purchase agreement. Once both parties have filed, they must observe a statutory waiting period, which typically lasts 30 days (15 days for certain transactions) and must be observed before the transaction can close. Parties can expedite review by filing based on executed letters of intent or, historically, by requesting early termination of the waiting period; however, the FTC and the DOJ issued a suspension of early terminations in early 2021 that was still in effect at the end of Q2 2023.

Transactions raising anticompetitive concerns may receive a "second request" from the reviewing agency, resulting in a significantly more extended review period. Recently, the FTC and DOJ have increased their review of PE-led deals and signaled that PE funds and their roll-up strategies will face greater scrutiny. For example, in 2022, the FTC brought two enforcement actions against PE firm JAB Consumer Products for its acquisitions of SAGE Veterinary Partners and Ethos Veterinary Health. Both firms were competitors of JAB's portfolio companies in the same industry. The consent agreements require JAB to divest competing specialty and emergency pet clinics in local markets. At the same time, the FTC is also requiring JAB to obtain prior approval before it can acquire any specialty or emergency veterinary clinics in certain areas for over 10 years.

The FTC and DOJ have also increased their focus on acquisition transactions, releasing two proposed enforcement objectives in the last few months. On June 27, 2023, the FTC, with the concurrence of the DOJ, announced proposed rules that, once implemented, will significantly increase the amount of information that transaction parties will need to include in their HSR filings. After the proposed new rules are implemented, it is expected that the estimated average preparation time for completing HSR filings will extend well beyond the typical five to 10 business days following the execution of a purchase agreement, potentially delaying closings. Among the proposed changes affecting private equity firms, limited partners that hold a 5% or greater interest in a partnership would be required to be disclosed in HSR filings (in addition to general partners, who are currently required to be disclosed for partnerships).

On July 19, 2023, the DOJ and FTC announced new draft Merger Guidelines, which are subject to public comment for 60 days. The draft Merger Guidelines are intended to increase merger enforcement, including enforcement against serial or roll-up acquisitions. The draft Merger Guidelines identify concerns with "a firm that engages in an anticompetitive pattern or strategy of multiple small acquisitions in the same or related business lines" even if no single acquisition would violate the antitrust laws. The agencies are concerned that "a cumulative series of mergers" may substantially lessen competition or tend to create a monopoly.

In addition, parties to transactions potentially affecting national security may seek regulatory clearance from CFIUS. Given recent political developments, regulatory changes, and increased resources available to CFIUS, 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.

The Biden Administration as well as the U.S. Congress are considering measures to review outbound investments from the United States for national security concerns. These potential measures are largely driven by concerns related to U.S. capital flowing into sectors of the Chinese economy that support the Chinese government's "military-civil fusion" regime, which seeks to develop the most technologically advanced military by removing barriers between civilian and defense sectors. As a result, the measures will likely target investments in Chinese sectors such as artificial intelligence, semiconductors, and quantum computing and/or involving military and dual-use technologies. The first phase of an outbound investment review mechanism will likely center around requiring notifications to the U.S. government for investments in the applicable sectors of the Chinese economy as a means for the U.S. government to collect information about such activities. At this time, the U.S. government is unlikely to impose a "reverse CFIUS" process that requires investors to seek U.S. government approval for in-scope outbound investments, though such a requirement could materialize in the future. The U.S. government was expected to announce relevant measures in early 2023, but that announcement was pushed back and the timing is now unclear, although we anticipate seeing movement in this area in late 2023.

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?

For years, competitive auctions have been 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 prior to 2022, transaction terms shifted strongly in favor of sellers, including the limiting of conditionality and post-closing indemnification obligations. Transactions have commonly been consummated with public-style closing conditions (i.e., representations subject to MAE bring-down), financing conditions have disappeared, and reverse break fees are common. The use of representations and warranties ("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 R&W 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.

Starting in the second half of 2022, with the market for M&A softening and there being an increase in proprietary deals and auctions with a lack of interested bidders, there has been a noticeable shift to more buyer-friendly terms, including lower purchase prices, extended exclusivity periods and use of earn-outs being used to offset upfront cost at closing and to bridge the valuation gap. Given the increasing cost of debt, rising inflation and the volatility of the market, we expect to see these trends continue for the foreseeable future.

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. Public company transactions also present unique challenges for the use of creative financing methods such as earn-outs, contingent value rights and seller financing.

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 3–4%.

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. U.S. transactions typically involve a working capital adjustment (as opposed to a locked-box approach) 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. Over the last year, the challenging market conditions and the resulting valuation gaps have paved the way for a rise in earn-outs and other deferred consideration in transaction agreements.

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, if any, for a portion of the retention under the policy (e.g., 50% of a retention equal to 1% (or less) of enterprise value). Public-style walk-away deals where sellers provide no indemnification have become common, and proposing a walk-away deal may effectively be required for buyers 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. In recent years, limited non-competition covenants by PE sellers have become somewhat more common given the high valuations paid by buyers. However, these covenants, if present, 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 (including fiduciary duties owed to its LPs) and the business being sold.

Counsel should ensure that key members of the target's management team continue to be bound by existing restrictive covenants. The scope of permissible non-competition and other restrictive covenants varies significantly from state to state, and, in recent years, many courts have increased the level of scrutiny that they apply to such covenants. At a minimum, restrictive covenants must not be broader than necessary to protect the legitimate business interests of the company and be reasonable with respect to duration, geographic reach, and scope of restricted activities. Covenants that are overbroad face a risk of being unilaterally narrowed by a court or, as has become increasingly common over the last several years, declared unenforceable in their entirety. See question 11.1 for a discussion of the New York State Legislature's recent bill banning new employee non-competes and the FTC's proposed rules prohibiting employee non-competes.

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 5–10% 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 been expanded over the last few years to include liabilities related to PPP loans.

Despite competition among R&W insurers, consistent with other insurance markets, pricing of R&W insurance policies has relaxed slightly, with premiums and broker fees commonly around 3–4% of the policy limit, and underwriting due diligence fees of US$30,000–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?

For transactions with indemnification, representations and warranties typically survive for 12–24 months post-closing, with 12 months being most common, although certain specified representations may survive longer. For example, tax, employee benefit and fundamental representations often survive for several years or until expiration of the applicable statute of limitations. Fundamental representations typically include due organization, enforceability, ownership/capitalization, subsidiaries and brokers and may also include affiliate transactions. 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., 0.5% or an amount to cover the retention) is typically negotiated when the buyer is obtaining R&W insurance but the parties have not agreed to a full walk-away deal. Liability for breaches of fundamental representations, breaches of covenants and fraud is often uncapped or capped at the purchase price. Although dollar-one thresholds are sometimes used, 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 prevalence of R&W insurance across the market, escrows and holdbacks to cover indemnification for representation breaches are less common. However, for transactions with R&W insurance that are not 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 generally be named a third-party beneficiary. In a club deal, each PE sponsor may deliver 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. Reverse break fees can vary from 3–10% of the target's enterprise value, with the typical fee in the range of 5–7% of enterprise value, 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 come with the cost and compliance burden of the federal disclosure rules and are subject to volatile market conditions. In 2022 through the first half of 2023, PE exits via IPO have been almost nonexistent. Going public through an acquisition by a special purpose acquisition company ("SPAC") (i.e., a de-SPAC transaction) has decreased in popularity recently, given heightened regulatory scrutiny, the performance of recent de-SPAC transactions, increased litigation, decreased public company valuations and general uncertainty in the public markets.

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 re-election following the IPO. Absent submission of nominees by third-party stockholders through proxy contests, which tend to ebb and flow but are generally 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 can help 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, particularly as decreased public company valuations and an almost paralyzed IPO market have made IPOs (including de-SPAC transactions) significantly less attractive.

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 (including the syndicated loan market, private credit market and the high-yield bond market).

The most common sources of debt financing used to fund PE transactions are loans and high-yield bonds. Loans can be provided by traditional, regulated banks or direct lenders, such as alternative asset managers and BDCs, and may be syndicated among a large group of lenders or provided by a single lender or a smaller group of lenders through a club deal. Middle market PE sponsors typically look to the loan market to fund their PE transactions, and larger PE sponsors typically look to both the loan and high-yield bond markets to fund their large-cap deals.

Due to a number of macroeconomic and geopolitical challenges, including interest rate hikes and inflation, PE deal activity remains significantly down from 2021. The syndicated loan market and the high-yield bond market have been heavily impacted by these market conditions and have seen a significant decrease in deal activity. On the other hand, while still at a lower activity level than previous years, the private credit market led by direct lenders has remained relatively active compared to the syndicated loan and high-yield bond markets. Direct lenders continue to be the key players in PE transactions due to their competitive advantage over traditional regulated banks, including an ability to take on higher leverage, unconstrained by bank regulations, and provide faster deal execution and certainty of terms with no "market flex" risk. More direct lenders are now also equipped to fund large-cap PE transactions whereas, in the past, direct lenders typically only participated in smaller middle market deals. As market participants look for more efficient and creative ways to get deals done in a challenging economy, PE sponsors have also been utilizing seller notes and preferred equity financing to fund their acquisitions.

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?

Traditional banks continue to be governed by capital requirement guidelines and regulations affecting highly leveraged loans, including the Dodd-Frank Act. Some of these regulations were loosened in recent years in an effort to infuse capital and support the market during the COVID-19 pandemic. It remains to be seen whether similar guidelines and/or regulations will be imposed on direct lenders, as their role in the debt-financing market continues to increase, and whether a new, more restrictive regulatory scheme will be introduced or implemented with respect to traditional banks in light of the recent regional bank failures and bail-outs (including Silicon Valley Bank and others).

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

As fewer PE deals have been carried out, the PE financing market has also remained relatively slow throughout 2022 and the first half of 2023. In addition, due to higher pricing, most portfolio companies have refrained from refinancing their existing debt facilities, which has also contributed to the low level of activity in the PE financing market.

However, private credit funds have continued to actively raise capital, accumulating more "dry powder" to be deployed in the PE market, and direct lenders have continued to play an active role in PE financing transactions. In addition, the debt-financing market has seen a high volume of add-on acquisitions, as portfolio companies are still able to tap into existing revolver or delayed draw term loan facilities to fund those acquisitions, as well as "amend and extend" transactions as portfolio companies seek to extend the maturity of existing debt instead of refinancing it. In addition, nearing the cessation of LIBOR on June 30, 2023, the debt-financing market saw a high volume of amendments to existing debt facilities to convert LIBOR loans into SOFR loans.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

As a result of declines in exit activity, there has been significant growth in the use of continuation funds and GP-led secondaries

since 2020. With a scarcity of available investments and interested buyers, GPs use continuation funds to retain investments from a previous fund that the firm is not yet ready to sell, either because the asset is underperforming or, conversely, because it is performing well. Rolling these investments over to a new fund allows PE firms to release their LPs from commitments while also giving those who are interested in continuing the investment the opportunity to roll over into the new structure alongside new investors. Global secondary transaction volume increased from $60 billion in 2020 to around $134 billion in 2021 and $111 billion in 2022. We expect this trend to continue during 2023, as exit activity remains slow.

9.2 Are there any particular legal requirements or restrictions impacting their use?

Conflicts of interest are a major focal point for GPs when establishing a continuation fund because the PE sponsor is on both sides of the transaction. These conflicts can be managed by obtaining the requisite LP consents and keeping LPs informed and involved in the process. The PE sponsor needs to be able to articulate a compelling reason for establishing the fund and engaging in the transaction as well as justify the selling price as reasonable. This requires the GP to balance the obvious need to be profitable with the GPs fiduciary duties to its investors. Disclosure, communication and transparency are of the utmost importance. The Institutional Limited Partners Association has provided guidance on best practices for successful continuation fund transactions and recommends that a fund's investment advisory committee be involved as early as possible. PE sponsors also seek independent valuations of assets and formal fairness opinions from separate independent auditors as a way to alleviate any pricing concerns and demonstrate fairness to the sponsor's LPs. Fund organizational documents are also more commonly establishing requirements that should be met for creation of continuation funds so that fewer questions regarding the business purpose of such a transaction arise.

10 Tax Matters

10.1 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.

10.2 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, entitle holders to participate only in company appreciation (not capital) and provide holders with the possibility of reduced tax rates on long-term capital gains, but they do have certain complexities not present in alternative structures. 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.

10.3 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.

10.4 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. There have been changes to the tax audit process, and tax reform enacted in 2017 resulted in many material changes to the U.S. income tax system that continue to remain in effect. A series of legislative and non-legislative tax changes were made to the tax laws related to deductions for interest expense, use of carrybacks, deductions for the expense of certain types of property, and payroll taxes in response to the COVID-19 pandemic. In some cases, those rules were temporary in nature and their continuing impact should therefore be reviewed on a case-by-case basis.

More recently, a new corporate alternative minimum tax was enacted, imposing a 15% minimum tax on the adjusted financial statement income of large corporations (generally, applying to corporations with an average annual financial statement income of more than $1 billion) for taxable years beginning after December 31, 2022, and a new 1% corporate excise tax was enacted that applies to stock repurchases by publicly traded companies after December 31, 2022. In addition, significant additional funding of the U.S. Internal Revenue Service has been included in recent government budget proposals, including for increased enforcement for complex partnerships and large corporations.

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.

11 Legal and Regulatory Matters

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

The Tax Cuts and Jobs Act was enacted in 2017, there were legislative and other tax initiatives related to the COVID-19 pandemic, and more recent tax legislation went into effect after December 31, 2022. See section 10.

The Chair of the FTC and the Assistant Attorney General for DOJ's Antitrust Division have recently expressed concerns that certain types of PE transactions, including roll-up transactions, may harm consumers, workers, and marginalized communities. Antitrust officials have also identified PE acquisitions in the health care industry as particularly troublesome, as PE firms may be "focused on short-term gains and aggressive cost-cutting" that "can lead to disastrous patient outcomes and, depending on the facts, may create competition concerns." These concerns may lead to extended investigations, stronger consent agreements, or blocked deals. Stronger consent agreements include requiring PE firms to obtain prior approval before acquiring additional entities in the same market for 10 years.

The California Consumer Privacy Act of 2018, as amended by the California Privacy Rights Act ("CCPA"), went into effect on January 1, 2023. The law now protects personal information of California residents that is collected both in the business-to-business and employment contexts. Numerous other state-specific privacy laws also take effect in 2023, including in Colorado, Connecticut and Virginia, with laws in additional states to go into effect next year. There continues to be a flurry of state-level activity in the privacy space in the absence of a federal privacy or data breach notification law in the U.S. At the federal level, the FTC continues to be laser-focused on companies' data collection and sharing practices, with a particular focus on health information, biometric information and risks related to the use of AI. The Securities and Exchange Commission also remains active in the cyber space, proposing onerous data breach and cyber risk management requirements, including a proposed rule that would require registrants to provide periodic disclosures about policies and procedures for managing cybersecurity risks and cybersecurity incident reporting. The surge of activity at both the federal and state levels comes against the backdrop of an increase in ransom/cyber extortion and vendor/supply chain incidents. This has created a complex environment for PE buyers who need to gauge privacy risks associated with the data-driven companies they seek to acquire and with targets who are looking to present robust privacy and cybersecurity compliance programs.

In January 2023, the FTC issued a Notice of Proposed Rulemaking that would effectively prohibit the use of employee non-competition covenants in all but very limited circumstances. Specifically, if enacted (and not struck down by legal challenge), the rule would make it unlawful for an employer to enter into, or attempt to enter into, a non-compete agreement with any "worker," including any employee or independent contractor. The rule would also prohibit use of other types of contractual provisions, such as customer non-solicitation covenants, that have the effect of prohibiting a worker from seeking or accepting employment with an employer following the termination of employment. The proposed rule does not distinguish among types of employees and contains only a limited exception for individual sellers of a business who are "substantial" owners, members or partners in the business. The rule as drafted also applies retroactively and requires the affirmative rescission of existing non-competition agreements that violate the rule. The comment period with respect to the proposed rule is now closed and the FTC has yet to announce whether it intends to proceed with issuing the rule as originally drafted. Following its issuance, the rule is likely to be subject to numerous legal challenges. In addition, legislation by states restricting non-competes has also been on the rise. Most recently, the New York State Legislature passed a bill banning virtually all new employee non-competes. The bill was passed on June 7, 2023 by the New York State Senate, and on June 20, 2023 by the New York State Assembly. As of this writing, the New York state legislature is considering whether any changes should be made to the bill before it is sent to the Governor for review. Note that, by contrast with California's state-wide ban on non-competes and the FTC's proposed nationwide ban, the New York law as currently drafted does not contain any exceptions for sellers of businesses.

The U.S. government is considering implementing an outbound investment review mechanism that will likely focus on investments made from the United States in certain sectors of the Chinese economy. Measures currently under consideration would require notification by U.S. persons investing in targeted sectors; however, the initial measures are unlikely to require pre-clearance by the U.S. government for covered investments. The specific requirements and timing of the outbound investment reviews will be of great interest for U.S. investors over the coming months. See question 4.1.

In June 2023, the FTC announced proposed rules that would significantly increase the amount of information that parties to acquisition transactions need to include in their HSR filings. If implemented, these proposed rules would likely to increase the amount of time parties spend preparing for, and the FTC's review of, HSR filings. As a result, the proposed new rules could increase the interim period between signing and closing for applicable transactions. See question 4.1.

In July 2023, the DOJ and FTC announced draft new Merger Guidelines, which are intended to increase merger enforcement of entities that engage in patterns or series of acquisitions that may be anticompetitive. See question 4.1.

11.2 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 or personal data, 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's 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).

In addition, the FTC and DOJ have increased their review of PE transactions. See question 11.1.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

Impact investing and impact funds are on the rise. Impact investing involves allocating funds to assets that generate positive societal or environmental impact combined with financial returns. These investments, which can be made in both emerging and developed markets, attempt to solve unheeded societal and environmental challenges (rather than merely avoid harm, as with socially responsible investing). While the particulars differ, impact investment firms are generally still profit-seeking entities, requiring at least a return on invested capital and some additional disclosures related to its non-financial metrics. This type of investing differs from ESG, because impact is a strategy concerned with the types of investments a manager targets while ESG is focused on how individual companies interact with the world.

Whether a manager of an impact investment firm is subject to a different fiduciary standard when making an impact investment depends on what type of firm makes the investment. For example, a qualified pension plan trustee could not use pension funds for "impact investments" if there was evidence that such an investment would not have a positive return, and if the trustee pursued this investment against the evidence, the trustee would be abdicating his fiduciary responsibility to seek the maximum financial return for the plan's beneficiaries. In contrast, a charity manager could consider a particular investment's special relationship with the institution's charitable purposes. If an investment sacrifices financial return to further a non-financial purpose, the non-financial objectives and the non-financial factors considered must directly relate to the charitable purposes of the organization making the investment and disclosure should be made regarding the same. Large asset managers who are creating impact investing funds will want to ensure that the particular investments pursued align with the stated mission and impact objectives marketed to LPs and that their investment committee is informed throughout the diligence and deal selection process.

11.4 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 availability of public information, 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.

11.5 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 and possible violations identified need to be thoroughly evaluated and potentially self-reported to the relevant enforcement authorities. In particular, the imposition of numerous sanctions and export controls against Russia in 2022 and 2023 has led to intense scrutiny of a target's operations in, or connection to, Russia, to identify potential violations or impacts on revenue derived from Russia, among other issues.

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.

11.6 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 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"), if an entity sponsors a qualified defined benefit pension plan or participates in a multiemployer defined benefit pension plan (typically as part of a collective bargaining agreement with a union), that entity and all other entities in the same "controlled group" are jointly and severally liable for the entity's pension obligations (such as funding and withdrawal liability

obligations). A "controlled group" generally consists of a group of trades or businesses under common control, which generally requires at least 80% direct or indirect common ownership (measured by vote or value as to all classes of an entity's equity) between or among the entities involved. Historically, PE funds have not been considered to be engaged in a "trade or business" (and thus would not be part of the same controlled group as their respective portfolio companies), but in light of recent case law developments, there is now some uncertainty whether such treatment can be assured. Recent case law has applied a facts-intensive "investment plus" analysis to hold that a PE fund sponsor that had active involvement and broad authority in the management of a portfolio company was engaged in a "trade or business" for purposes of testing controlled group status. Consequently, if a court were to find that a PE fund sponsor was engaged in a "trade or business" based on the reasoning applied in the referenced case law and if such PE fund sponsor also had sufficient common ownership with a portfolio company group such that the PE fund sponsor was found to be a member of the same controlled group as that portfolio company group, the PE fund sponsor could be jointly and severally liable for the defined benefit pension liabilities of that portfolio company group. Moreover, it could logically follow that the court could then find that other portfolio company groups owned by the same PE fund sponsor could also be jointly and severally liable for the defined benefit pension liabilities of the first portfolio company group if the 80% common ownership thresholds were satisfied. PE fund sponsors should carefully consider how to structure their investments in portfolio companies with qualified defined benefit pension obligations and consult with knowledgeable legal counsel to attempt to minimize the controlled group liability exposure presented by the foregoing principles.

12 Other Useful Facts

12.1 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. See question 11.1. Tax continues to be a key value driver in PE transactions, with IRRs and potential risks depending on tax considerations. See section 10.

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 in 2023. See section 11.

PE investors also need to be aware of the FTC's and individual states' increased focus on employee non-competition covenants when negotiating employment arrangements with management. They should ensure that any such covenants are drafted narrowly so that they protect the legitimate business interests of the company and are reasonable with respect to duration, geographic reach and scope of restricted activities. See section 11.

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