# THE INTERNATIONAL COMPARATIVE LEGAL GUIDE TO: PRIVATE EQUITY 2020

6TH EDITION

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global legal group
59 Tanner Street
London SE1 3PL
United Kingdom
+44 207 367 0720
info@glgroup.co.uk
www.iclg.com

Consulting Group Publisher
Rory Smith

Sub Editor
Jenna Feasey

Senior Editor
Sam Friend

Head of Production
Suzie Levy

Chief Media Officer
Fraser Allan

CEO
Jason Byles

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# International Comparative Legal Guides

## Private Equity 2020

### Sixth Edition

Contributing Editors:
Christopher Field & Dr. Markus P. Bolsinger
Dechert LLP

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# Expert Chapters



# Q&A Chapters

# USA



John LaRocca


Dr. Markus P. Bolsinger


Allie M. Misner

Dechert LLP


## 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 remained healthy in 2019, though it decreased slightly in terms of both deal volume and value relative to the record-setting levels of 2018, while deal activity for the first quarter of 2020 increased in both respects relative to the same period in 2019. Deal activity in the first quarter of 2020 benefited from transactions that were signed prior to the impacts of the COVID-19 pandemic being fully realized in the United States and has slowed in the second quarter or 2020. Commitments in respect of PE fundraising increased during 2019 to reach record levels but declined during the first quarter of 2020.

Over the last 18 months prior to the onset of the COVID-19 pandemic in the United States, PE sponsors continued to be confronted with highly elevated valuations for new platform companies and seller-friendly terms created by expedited, competitive auctions. These valuations, coupled with record levels of dry powder and the lack of suitable targets, continued to create a challenging investment environment for buyers. As a result, activity during this period increased for portfolio company add-ons and alternative transactions such as carve-outs, strategic partnering transactions, minority investments, club deals and take-private transactions. In addition, PE sponsors focused significant attention on readying existing portfolio companies for exits.

Since the full onset of the pandemic in the United States, deal activity and valuations have been depressed due to a number of impacts from the pandemic, including increased uncertainty, pricing difficulties, decreased availability of debt financing, challenging business circumstances for many businesses and sectors of the economy, and various practical impediments to getting deals done. Some of the pre-COVID-19 trends described above may continue for transactions that are successfully completed in the balance of 2020 due to the continuing presence of record levels of dry powder and the need for PE funds to put capital to work, but some deal dynamics may change. The impacts of COVID-19 will undoubtedly be felt throughout the U.S. PE industry in 2020, but we are beginning to see an uptick in deals as many regions of the country have begun the process of reopening. See question 1.3.

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

Over the last few years prior to the COVID-19 pandemic, the dearth of suitable targets has resulted in extremely competitive auctions, which in turn has resulted in historically high selling multiples and seller-favorable terms. Successful bids often included "walk-away" terms with few conditions and recourse limited solely to buyer-obtained representation and warranty ("R&W") insurance. With bankers and sellers focused on certainty and speed to closing, transactions were often required to be signed and closed within days or a few weeks. The COVID-19 pandemic has begun to shift some of those terms and timelines, as parties increasingly focus on allocating risk, travel restrictions and other obstacles make in-person meetings and visits to a target's facilities difficult, and decreased access to debt financing may result in slower processes and fewer ready buyers. See question 1.3. In addition, recent regulatory reforms involving the Committee on Foreign Investment in the United States ("CFIUS") could lead to increased timing delays and deal uncertainty for transactions involving non-U.S. investors that might raise U.S. national security issues.

### 1.3 What are going to be the long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic?

The long-term effects of the COVID-19 pandemic on U.S. PE are not yet known and will depend on a number of factors, but certain trends are likely to emerge.

In the shorter term, many funds and potential targets have turned their attention away from active deal-making and towards crisis management. For transactions that are being negotiated during this time, there is an increased focus on allocating risk, in particular relating to the economic impacts of COVID-19, which puts pressure on valuations and deal terms relating to conditionality and closing certainty and the parties'



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obligations between signing and closing, among others. The decreased availability of debt financing is a significant factor in what deals can get done, and the lack of abundant debt financing may result in less competition among buyers. Exits by PE funds were down in 2019 and the first quarter of 2020, and that pattern will likely continue as sponsors delay exits and wait for a more stable pricing environment, rather than selling portfolio companies at discounted valuations, or with a significant portion of the purchase price subject to an earn-out or deferred purchase price with seller financing.

Against that backdrop, sponsors continue to have access to record levels of dry powder and will be looking for ways to deploy capital. That is expected to lead to an increase in buyouts of distressed assets, private investments in public equity ("PIPEs"), carve-outs and minority investments, as well as an increase in smaller deals and add-ons acquisitions for existing portfolio companies that may be easier to finance than large platform acquisitions. In particular, those transactions may be easier to finance due to relationships with existing lenders and their familiarity with the platform's business. In addition, direct lending by private debt funds, which has increasingly become a source of financing for middle-market PE transactions over the last several years, may have an edge over traditional bank lending in the current environment; private debt funds, like PE funds, have access to significant amounts of dry powder and may have more willingness and flexibility to lend in a downturn.

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

Over the past several years, the concentration of capital in large, multi-strategy asset managers has increased, leading to a corresponding increase in the number of deals consummated by such managers. We expect this trend to continue, as large, multi-strategy asset managers may be better positioned than some others to weather the difficult current environment.

Non-traditional PE funds such as sovereign wealth funds, pension plans and family offices have been extending beyond minority positions to increasingly serve as lead investors in transactions, which has created additional competition for traditional PE funds.

In addition, pension funds, insurance companies and other investors of large pools of capital will likely continue increasing their allocation to alternative investments – PE, private debt, real estate and infrastructure.

## 2 Structuring Matters

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

The most common acquisition structures are mergers, equity purchases and asset purchases in the case of private targets, and one-step and two-step mergers in the case of public targets.

Historically, most PE sponsors have prioritized control investments, but the current market has increased focus on alternative investment structures, including structured equity.

**2.2 What are the main drivers for these acquisition structures?**

The primary drivers include tax considerations, stockholder approval, speed and certainty of closing and liability issues.

Mergers offer simple execution, particularly where the target has numerous stockholders, but buyers lack privity with the target's stockholders, and the target's board may expose itself to claims by dissatisfied stockholders. Buyers often seek separate agreements with stockholders that include 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 because buyers can obtain a step-up in tax basis in acquired assets. See section 9. Depending on the negotiated terms, buyers also may leave behind existing liabilities of the target. However, asset purchases (especially carve-out transactions) can be difficult and time-consuming to execute because third-party contract consents may be required. For certain regulated businesses, permits and licenses may need to be transferred or reissued. In addition, buyers need to carefully review the business' assets and liabilities to ensure that all necessary assets are acquired and that liabilities that flow to buyers as a matter of law are not unwittingly inherited.

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

U.S. PE returns typically arise from management fees and returns on equity investments. Equity structuring varies depending on the PE sponsor involved, the portfolio company risk profile and the IRR sought. Equity is most often comprised of preferred and/or common equity interests held by the PE sponsor. Often, some or each type of equity is offered to existing or "rollover" target investors. Preferred equity can be used to set minimum returns and incentivize common or other junior security holders to drive portfolio company performance. PE funds often offer portfolio company management equity-based incentive compensation in the form of stock options, restricted stock, phantom or other synthetic equity or profits interests, each of which is subject to vesting requirements. Carried interests are typically found at the fund level and do not directly relate to the structuring of the equity investment at the portfolio company level.

The main drivers for these structures are (i) alignment of interests among the PE sponsor and any co-investors, rollover investors and management, including targeted equity returns, (ii) tax efficiency for domestic and international fund investors and other portfolio company investors, including management, and (iii) incentivizing management.

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

Minority investments create financial and legal issues not often encountered in control investments. Unlike control transactions, where the PE sponsor generally has unilateral control over the portfolio company, minority investors seek to protect their investment through contractual or security-embedded rights.



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Rights often include negative covenants or veto rights over major business decisions, including material M&A transactions, affiliate transactions, indebtedness above certain thresholds, annual budgets and business plans, strategy, senior management hiring/firing and issuance of equity. In addition, PE sponsors will seek customary minority shareholder protections such as board and committee representation, information and inspection rights, tag-along and drag-along rights, registration rights and pre-emptive rights.

For transactions subject to CFIUS review, non-U.S. PE investors taking a minority position might be required to forego certain rights that it otherwise would seek (e.g., board representation and access to non-public information) in order to avoid triggering CFIUS review or to otherwise facilitate obtaining CFIUS clearance.

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

Management equity is typically subject to time- and/or performance-based vesting. Time-based awards vest in specified increments over several years (typically four to five years (in the Eastern United States) and sometimes less (in the Western United States)), subject to the holder's continued employment. Performance-based awards vest upon achieving performance goals, often based on the PE sponsor achieving a certain IRR or invested capital multiple upon exit. Time-based awards typically accelerate upon the PE sponsor's exit. Forfeiture of both vested and unvested equity in the event of a termination for cause is not uncommon.

Compulsory acquisition provisions are not typical, but portfolio companies customarily reserve the right to repurchase an employee's equity in connection with the employee's termination at fair market value or the lesser of fair market value and the original purchase price, depending on the timing and reason for termination.

The proportion of equity allocated to management (as well as the allocation among executives) varies by PE fund and the capital structure of the portfolio company, but management equity pools for portfolio companies typically range from 7.5%–15% of equity on a fully-diluted basis, with the higher end of that range being more common with smaller equity investments.

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

Management equity holders are typically treated as good leavers if their employment is terminated without cause, they resign with good reason or after a specified period of time, or their employment terminates due to death or disability. Bad leavers are commonly those who are terminated for cause or who otherwise resign without good reason.

## 3 Governance Matters

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

PE sponsors generally form new buyer entities (most often corporations or tax pass-through entities such as limited liability companies ("LLCs") or limited partnerships) through which they complete acquisitions and maintain their ownership interest in underlying portfolio companies. Governance arrangements are typically articulated at the portfolio company level where management holds its investment but may also be found at the buyer level if co-investors or management investors hold equity interests in the buyer. For control investments, PE sponsors will often control the manager and/or the board of both the buyer and the portfolio company.

Governance agreements among PE sponsors, co-investors and management will most commonly be in the form of a shareholders' agreement or LLC agreement. These agreements ordinarily contain (i) transfer restrictions, (ii) rights of first refusal or first offer, (iii) tag-along and drag-along rights, (iv) pre-emptive rights, (v) rights to elect the manager or board of directors, (vi) information rights, (vii) special rights with respect to management equity, including repurchase rights, and (viii) limits on certain duties to the extent permitted by state law. For larger portfolio companies contemplating exits through IPOs, registration rights may also be sought. Governance arrangements are not generally required to be made publicly available unless the portfolio company is a public reporting company. Charters are required to be filed with the state of organization but generally do not include meaningful governance provisions.

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

For control investments, PE sponsors will often control the portfolio company through their rights to appoint the manager or a majority of the directors. As a result, major corporate actions are ultimately indirectly controlled by the PE sponsor. If a PE sponsor takes a minority position, veto rights will generally not be included in underlying governance arrangements unless the sponsor owns a substantial minority position. See question 2.4.

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

Veto rights are typically contractual rights in favor of specified shareholders or classes of equity contained in a shareholders' agreement or LLC agreement if applicable, and are generally enforceable. For corporations, although less common, negative covenants can also be included in the articles of incorporation, which would render any action taken in violation of one of those restrictions *ultra vires*. Although shareholder-level veto rights are sometimes employed, director-level veto rights are less common, as veto rights exercised by directors will be subject to their overriding fiduciary duty owed to the portfolio company. See question 3.6.

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

Whether a PE investor owes duties to minority shareholders requires careful analysis and will depend upon several factors,



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including the legal form of the entity involved and its jurisdiction of formation.

Several jurisdictions hold that all shareholders in closely held companies owe fiduciary duties to each other and the company. In other jurisdictions, such as Delaware, only controlling shareholders owe fiduciary duties. In this context, the ability to exercise dominion and control over corporate conduct (even if less than 50% of the equity is owned) will be determinative.

Delaware is frequently chosen as the state of organization in PE transactions due to its well-developed business law and sophisticated judiciary. Under Delaware law, duties arising from controlling ownership include fiduciary duties of care and loyalty and other duties such as those arising under the corporate opportunity doctrine. The duty of care requires directors to make informed and deliberate business decisions. The duty of loyalty requires that decisions are made in the best interests of the company and its shareholders and not based on personal interests or self-dealing. For Delaware corporate entities, these duties may not be waived.

For PE sponsors organizing their investment vehicles as LLCs in Delaware, the underlying LLC agreement will often include an express waiver of fiduciary duties owed to minority investors. Absent an express waiver, courts will apply traditional corporate-like fiduciary duties. Other duties deemed included in LLC agreements such as duties of good faith and fair dealing may not be waived. In addition, shareholders' and LLC agreements often include express acknowledgments that the PE sponsor actively engages in investing and has no obligation to share information or opportunities with the portfolio company. LLC agreements also typically provide that portfolio companies (and not PE sources) serve as the first source of indemnification for claims against PE sponsor employees serving on the portfolio company's board.

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

Shareholders' and LLC agreements are generally governed by and must be consistent with the laws of the state of the entity's formation. LLC agreements, which are contracts among the company and its members, provide greater flexibility than shareholders' agreements. Although governing law and submission to jurisdiction provisions may refer to the law of other states, or may apply the law of two or more states through bifurcation provisions, this approach is unusual and should be avoided, as it is unduly complicated and references to state laws outside the state of formation may render certain provisions unenforceable.

Non-competition and non-solicitation provisions in shareholders' and LLC agreements generally restrict management and non-PE co-investors, but not PE investors. These provisions are subject to the same enforceability limitations as when contained in other agreements. Enforceability will be governed by state law and must be evaluated on a case-by-case basis. The agreements must be constructed to protect the legitimate interests of the portfolio company and not violate public policy. Unreasonable temporal and/or geographic scope may render provisions unenforceable or subject to unilateral modification by courts. Other contractual provisions such as transfer restrictions, particularly for corporate entities, are subject to public policy limitations.

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

There are no meaningful legal restrictions applicable to PE investors nominating directors to private company boards, other than restrictions under applicable antitrust laws. For example, the Clayton Act generally prohibits a person from serving as an officer or director of two competing corporations. In 2019, the U.S. Department of Justice (the "DOJ") expressed a desire to extend the scope of these restrictions on interlocking directorships to non-corporate entities and entities that appoint directors to competing entities as representatives or "deputies" of the same investor. If the Clayton Act is expanded in such a manner, PE funds may need to reevaluate their existing corporate governance arrangements with their portfolio companies. 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.

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 where fiduciary duties of directors are permitted to be, and have been, expressly disclaimed). Directors of corporations cannot delegate their decision-making responsibility to or defer to the wishes of a controlling shareholder, including their PE sponsor. In addition, conflicts of interest may arise between the PE firm and the portfolio company. Directors should be aware that they owe a duty of loyalty to the company for the benefit of all of its shareholders (absent a waiver under the circumstances discussed above) and that conflicts of interest create exposure for breach of duty claims. Finally, while the fiduciary duties to the company remain the same, the ultimate stakeholders might change when a company is insolvent or in the zone of insolvency – as a result, directors may owe fiduciary duties to certain creditors of the portfolio company in the event such entity is insolvent or within the zone of insolvency.

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

See question 3.6. Under the duty of loyalty, directors must act in good faith and in a manner reasonably believed to be in the best interests of the portfolio company and may not engage in acts of self-dealing. In addition, directors appointed by PE firms who are also PE firm officers owe potentially conflicting fiduciary duties to PE fund investors. Directors need to be cognizant of these potential conflicts and seek 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



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diligence process, negotiation of definitive documentation, and obtaining debt financing, third-party consents and regulatory approvals.

Antitrust clearance is the most common regulatory clearance faced. Generally, only companies that meet regulatory thresholds are required to make filings under the Hart-Scott-Rodino Act ("HSR"). The most significant threshold in determining reportability is the minimum size of transaction threshold (2020: US$94 million). In most circumstances, the HSR process takes approximately one month and is conducted between signing and closing. However, parties can expedite review by filing based on executed letters of intent or by requesting early termination of the waiting period.

Transactions raising anticompetitive concerns may receive a "second request" from the reviewing agency, resulting in a more extended review period.

In addition, parties to transactions potentially affecting national security may seek regulatory clearance from CFIUS. Given recent political developments and regulatory changes, buyers should expect enhanced scrutiny by the U.S. government of certain foreign investments in the United States, particularly in the technology and defense-related industries. Recent CFIUS reforms that have been implemented pursuant to the Foreign Investment Risk Review Modernization Act of 2018 ("FIRRMA") have expanded CFIUS' powers and also now require mandatory submissions to CFIUS for certain types of transactions that are more likely to raise U.S. national security concerns – previously, CFIUS was typically a voluntary process. Prudent buyers seek CFIUS approval to forestall forced divestiture orders.

Other contractual or government approvals relating to specific sectors or industries (e.g., the Jones Act) may also be necessary or prudent depending on the nature of the business being acquired or the importance of underlying contracts.

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

Over the past few years, competitive auctions have become the preferred method for exits by PE sponsors and other sellers in the United States. As a result of these competitive auctions, the scarcity of viable targets and the abundant availability of equity financing and, prior to the COVID-19 pandemic, debt financing, transaction terms have shifted strongly in favor of sellers, including the limiting of conditionality and post-closing indemnification obligations. Transactions are generally being consummated with "public"-style closing conditions (i.e., representations subject to MAE bring-down), financing conditions have virtually disappeared, and reverse break fees are increasingly common. The use of R&W insurance has been implemented across transactions of all sizes and is now used equally by PE and strategic buyers. Transactions are being structured more frequently as walk-away deals, with the insurance carrier being responsible for most breaches of representations between the retention (which refers to the self-insured deductible) and insured limit under the policy. It also is becoming more common to include terms regarding CFIUS in transactions involving non-U.S. investors.

The COVID-19 pandemic and its impacts on PE will likely shift some of these trends in the short term. See question 1.3.

## 5 Transaction Terms: Public Acquisitions

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

Public company acquisitions pose a number of challenges for PE sponsors. The merger proxy or tender offer documents provided to target shareholders will include extensive disclosure about the transaction, including the buyer and its financing, and a detailed background section summarizing the sale process and negotiations. These disclosure requirements are enhanced if the Rule 13e-3 "going private" regime applies to the transaction.

A public company acquisition will require either consummation of a tender offer combined with a back-end merger or target shareholder approval at a special shareholder meeting. In either case, there will be a significant delay between signing and closing that must be reflected in sponsor financing commitments, with a minimum of six weeks for a tender offer (which must remain open for 20 business days) and two to three months for a merger that requires a special meeting.

Absent unusual circumstances, there will be no ability to seek indemnification or other recourse for breaches of target representations or covenants, but R&W insurance may be obtained.

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

Generally, the acquisition of a U.S. public company is subject to the ability of the target's board to exercise a "fiduciary out" to pursue superior offers from third parties until the deal is approved by the target shareholders or a tender offer is consummated. A PE buyer typically negotiates an array of "no shop" protections that restrict the target from actively soliciting competing bids, along with matching and information rights if a third-party bid arises. If a target board exercises its fiduciary out to terminate an agreement and enter into an agreement with an unsolicited bidder, or changes its recommendation of the deal to shareholders, break-up fees are customary. Fees typically range from 2%–4%.

## 6 Transaction Terms: Private Acquisitions

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

U.S. PE buyers typically purchase companies on a cash-free debt-free basis. As opposed to a locked box approach, U.S. transactions typically involve a working capital adjustment where the parties agree to a target amount that reflects a normalized level of working capital for the business (often a trailing six- or 12-month average) and adjust the purchase price post-closing to reflect any overage or underage of working capital actually delivered at closing. Depending on the nature of the business being acquired and the dynamics of the negotiations, particularly in light of COVID-19 pricing uncertainties, the price may also include earn-outs or other contingent payments that provide creative solutions to disagreements over the target's valuation.



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### 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 increasing prevalence of R&W insurance, post-closing indemnification by sellers, which was once intensely negotiated, has become less important for allocating risk between buyers and sellers. Historically, sellers would indemnify buyers for breaches of representations and warranties, breaches of covenants and pre-closing tax liabilities, and the parties would carefully negotiate a series of limitations and exceptions to the indemnification.

When buyers obtain R&W insurance, sellers typically provide only limited indemnification for a portion of the retention under the policy (e.g., 50% of a retention equal to 1% of enterprise value). Public-style walk-away deals where sellers provide no indemnification are increasingly common, and proposing a walk-away deal provides bidders an advantage in competitive auctions.

For issues identified during due diligence, buyers may negotiate for special indemnities, with the terms depending on the nature and extent of the exposure and the parties' relative negotiating power.

Management team members typically do not provide any special indemnification to buyers in their capacity as management.

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

Historically, U.S. PE sellers typically have not agreed to non-competition covenants, and restrictive covenants were limited to employee non-solicitation covenants. Conversely, selling management investors and certain co-investors typically agree to non-competition and other restrictive covenants. Recently, limited non-competition covenants by PE sellers have become more common given the high valuations paid by buyers. However, these covenants are typically very narrow and may be limited to restrictions on purchasing enumerated target companies. Restrictive covenants by PE sellers tend to be intensely negotiated, and the terms, including the length of the restrictions, any exceptions and their applicability to PE fund affiliates, depend on the parties' negotiating strength and the nature of the PE seller and the business being sold.

Counsel should ensure that non-selling members of the target's management team continue to be bound by existing restrictive covenants.

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

PE and other sophisticated sellers routinely request that recourse be limited to R&W insurance obtained by buyers.

Policy terms commonly include coverage limits of 10%–15% of target enterprise value, a 0.75%–1% retention (stepping down to 0.5% after one year), six years of coverage for breaches of fundamental representations and three years of coverage for breaches of other representations. Exclusions include issues identified during due diligence, certain liabilities known to the buyer, benefit plan underfunding and certain environmental liabilities, and may also include industry and deal specific exclusions based on areas of concern arising during the underwriting process. In addition, exclusions have recently been expanded to include COVID-specific exclusions.

Pricing of policies has grown more favorable in recent years, with premiums commonly around 3% or less of the policy limit (although the industry expects rates to increase based on recent claims experience) and underwriting due diligence fees of US$25,000–US$50,000. In addition, the premium is subject to taxation under state law, and the insurance broker will also collect a fee.

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

Representations and warranties typically survive for 12–24 months post-closing, with 12 months increasingly becoming the norm, although certain specified representations may survive longer. For example, tax, employee benefit and fundamental representations often survive until expiration of the applicable statute of limitations. Fundamental representations typically include due organization, enforceability, ownership/capitalization, subsidiaries and brokers.

For transactions without R&W insurance, indemnification caps typically range from 5%–20% of the purchase price, whereas a significantly lower cap (e.g., 1%) is typically negotiated when the buyer is obtaining R&W insurance. Liability for breaches of fundamental representations, breaches of covenants and fraud is often uncapped. Sellers will often only be responsible for damages above a deductible amount.

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

With the continuing increase in usage of R&W insurance, escrows and holdbacks to cover indemnification for representation breaches are becoming less common. However, for non-walk-away deals, sellers generally place 50% of the retention under the R&W insurance policy in escrow. Escrows for post-closing purchase price adjustments remain common, as do special escrows to address issues identified during due diligence.

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

U.S. PE buyers typically fund acquisitions through a combination of equity and third-party debt financing. The PE sponsor will deliver an equity commitment letter to the buyer under which it agrees to fund a specified amount of equity at closing, and the seller will be named a third-party beneficiary. In a club deal, each PE sponsor typically delivers its own equity commitment letter.

Committed lenders will deliver debt commitment letters to the buyer. Often, PE buyers and their committed lenders will limit sellers' rights to specifically enforce the debt commitment. See question 6.8.



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

In the current market, closings are rarely, if ever, conditioned on the availability of a buyer's financing. In certain circumstances, PE buyers may accept the risk that they could be forced to close the transaction by funding the full purchase price with equity. However, buyers seeking to limit such exposure typically negotiate for a reverse break fee, which allows termination of the transaction in exchange for payment of a pre-determined fee if certain conditions are satisfied. Depending on the terms, reverse break fees may also be triggered under other circumstances, such as a failure to obtain HSR approval. Typical reverse break fees range from around 4%–10% of the target's equity value, with an average of around 6%–7%, and may be tiered based on different triggering events. Where triggered, reverse break fees typically serve as a seller's sole and exclusive remedy against a buyer. Given that PE buyers typically have no assets prior to equity funding at closing, sellers commonly require PE sponsors to provide limited guarantees of reverse break fees.

## 7 Transaction Terms: IPOs

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

Exits through IPOs will often be at higher multiples and more readily apparent market prices than exits through third-party sale transactions. However, exits through IPOs are subject to volatile market conditions and present other significant considerations.

Unlike third-party sales, PE sponsors continue to own significant amounts of portfolio companies' equity following an IPO. As a result, PE sponsors' ownership interests and rights and the nature of any affiliate transactions with portfolio companies will be subject to public disclosure and scrutiny. PE sponsor management and monitoring agreements commonly terminate in connection with IPOs.

Seeking to retain control over their post-IPO stake and ultimate exit, PE sponsors often obtain registration rights and adopt favorable bylaw and charter provisions, including board nomination rights, permitted stockholder action by written consent and rights to call special stockholder meetings. Because many U.S. public companies elect board members by plurality vote, PE sponsors often retain the right to nominate specific numbers of directors standing for reelection following the IPO. Absent submission of nominees by third-party stockholders through proxy contests, which are unusual in the United States, PE sponsors can ensure election of their nominees. As these favorable PE rights are unusual in U.S. public companies, the rights often expire when the sponsor's ownership falls below specified thresholds.

Unlike private companies, most U.S. public companies are subject to governance requirements under stock exchange rules such as independent director requirements.

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

The underwriters in an IPO typically require PE sellers to enter into lock-up agreements that prohibit sales, pledges, hedges, etc. of shares for 180 days following the IPO. After the expiration of the lock-up period, PE sponsors will continue to be subject to legal limitations on the sale of unregistered shares, including limitations on the timing, volume and manner of sale.

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

Depending on market conditions, PE sponsors may simultaneously pursue exit transactions through IPOs and private auction sales. Dual-track transactions often maximize the price obtained by sellers (through higher IPO multiples or increased pricing pressure on buyers), lead to more favorable transaction terms and provide sellers with greater execution certainty. The path pursued will depend on the particular circumstances of the process, but ultimate exits through private auction sales remain the most common.

Dual-track strategies have historically depended on the size of the portfolio company and attendant market conditions. Dual-track approaches are less likely for small- to mid-size portfolio companies, where equity values may be insufficient to warrant an IPO. In addition, such companies are less likely to have sufficient resources to concurrently prepare for both an IPO and third-party exit. As volatility in IPO markets increases, PE firms generally focus more on sales through private auctions where closing certainty and predictable exit multiples are more likely.

## 8 Financing

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

The most common debt sources are bank loans, private debt (known as "direct lending") and high-yield bonds. Debt is categorized by its place in the capital structure and the associated risk to the lender. Senior debt ranks above all other debt and equity of the business and is first in line for repayment. Senior secured debt includes revolving facilities, with advances made on the basis of borrowing bases (asset-based loans) or cash flow, and term debt. Second lien or junior lien loans are equal in right of payment to holders of senior secured debt but rank behind such holder's security in the assets of the business. Mezzanine and other subordinated debt is subordinated in right of payment to holders of senior debt, often unsecured and sometimes includes equity kickers. Unitranche facilities combine senior and subordinated debt in one facility, typically with a blended rate of interest.

Leveraged loans are currently favored over high-yield bonds due to competitive pricing, similar flexible covenant terms, ease of amendment and limited prepayment premiums.

Direct lenders continue to be important market players and have competitive advantages over traditional bank lenders. Those advantages initially stemmed from constraints on traditional bank lenders by capital requirement guidelines and by regulatory restrictions affecting loans exceeding certain leverage thresholds. While those guidelines and restrictions have been pulled back, borrowing from direct lenders has continued to be a trend in light of the amount of money in the market generally and such lenders' flexibility in commitment amounts, loan terms and speed in execution.



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

The target of an ongoing push for deregulation in the United States is the Dodd-Frank Act, including the Volcker Rule, a regulation that was meant to prohibit banks from making speculative bets with their own capital. The result of this push was a roll-back of Dodd-Frank regulations late last year, simplifying the process for determining which types of proprietary trading restrictions apply to certain banking entities. This year, the proposal on the table is to eliminate a 3% cap on ownership of a venture capital fund and to allow banks to invest in credit funds among other changes.

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

The most important trends in the U.S. loan market relate to the effect of the COVID-19 pandemic on the credit facilities of portfolio companies and include the following:

- At the start of the lockdowns across the United States, many companies chose to draw on their revolvers to ensure they would have adequate liquidity to meet the needs of their businesses, including additional cleaning and other costs relating to COVID-19-specific issues. Recently, in response to the drawdowns, lenders have tried to implement "anti-hoarding" provisions that would require the regular repayment of cash over an agreed upon threshold. Borrowers have resisted such to ensure access to the full amount of their revolver at all times.
- PE sponsors and management also have carefully reviewed the definition of "EBITDA" in credit facilities to determine whether any add-backs are available with respect to lost earnings attributable to the health crisis and attendant costs and expenses that may be incurred in connection therewith. If the effects of the crisis are "extraordinary, unusual or non-recurring," then an add-back to EBITDA may well be available for many borrowers for the associated expenses, charges, losses and/or items. Also, as part of the EBITDA add-back review, PE sponsors are reviewing the applicability of existing business interruption insurance. The proceeds of such insurance coverage, if paid, would often be permitted to be added back to EBITDA for purposes of covenant compliance. However, whether or not business interruption insurance is available will depend on the language of the particular policy.
- Some portfolio companies are experiencing breaches arising from COVID-19 related impacts on their business. If a breach appears inevitable, PE sponsors, management and lenders have entered into discussions regarding potential solutions. Some of those solutions include a payment holiday or an amendment converting upcoming payments into payment-in-kind ("PIK") payments or the exercise of an "equity cure" right to either cure the breach or even prevent a technical breach from occurring in the first instance. When government-mandated lockdowns are lifted and all parties have greater visibility with respect to future performance, PE sponsors, management and lenders will likely seek to enter into longer-term solutions.

## 9 Tax Matters

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

For non-U.S. investors, considerations include structuring the fund and investments in a manner that prevents investors from having direct exposure to U.S. net income taxes (and filing obligations) and minimizes U.S. tax on dispositions or other events (e.g., withholding taxes). Holding companies ("blockers") are often used and, in some cases, domestic statutory exceptions or tax treaties may shield non-U.S. investors from direct exposure to U.S. taxes.

For U.S. investors, considerations include minimizing a "double tax" on the income or gains and, in the case of non-corporate U.S. investors, qualifying for reduced tax rates or exemptions on certain dividend and long-term gains.

There is also a focus in transactions on maximizing tax basis in assets and deductibility of costs, expenses and interest on borrowings, as well as state and local income tax planning.

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

Tax-efficient arrangements depend on portfolio company tax classification. For partnerships (including LLCs taxed as partnerships), profits interests can provide meaningful tax efficiencies for management. Profits interests are granted for no consideration and entitle holders to participate only in company appreciation (not capital), and provide holders with the possibility of reduced tax rates on long-term capital gains (but do have certain complexities not present in less tax-efficient alternatives). Other types of economically similar arrangements (non-ISO stock options, restricted stock units and phantom equity) do not generally allow for this same capital gain treatment.

Profits interests are not available for corporations. In certain cases, the use of restricted stock that is subject to future vesting (together with the filing of an 83(b) election) can enable a holder to benefit from reduced tax rates on long-term capital gains.

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

Management investors selling their investment focus on qualifying for preferential tax rates or tax exemptions on income.

Management investors rolling part of their investment seek to roll in a tax-deferred manner, which may be available depending on the nature of the transaction and management's investment. In some cases (such as phantom or restricted stock unit plans), tax deferral is not achievable or may introduce significant complexity.

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

There have been a number of significant changes in recent years.



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Significant changes to the tax audit process have become effective, and significant tax reform enacted in 2017, commonly referred to as the Tax Cuts and Jobs, resulted in many significant changes to the U.S. income tax system. Most recently, and related to the COVID-19 pandemic, there has been a series of tax legislation and non-legislative changes impacting the U.S. income tax system. This has included new rules that create or modify tax laws related to deductions for interest expense, use of carrybacks, and deductions for the expense of certain types of property, the extension of deadlines for tax payments and tax returns, payroll tax incentives including new refundable tax credits and payment deferrals. It is possible that further legislation or other initiatives relating to COVID-19 matters could be enacted.

These changes could impact the timing and amount of deductions and tax payments of portfolio companies, and therefore will be relevant to PE transactions involving U.S. companies.

## 10 Legal and Regulatory Matters

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

Significant legislation was adopted in 2017 (the Tax Cuts and Jobs Act), and even more recently there has been legislative and other tax initiatives related to the COVID-19 pandemic. See section 9.

The enactment of FIRRMA in August 2018 and the implementation of related regulations that culminated in early 2020 has led to significant reforms to CFIUS. In particular, the scope of transactions that could be subject to CFIUS review has been expanded, certain filings are now mandatory, and there is an increased focus on particularly sensitive industries. These changes have led to increased timing delays for transactions that require CFIUS review and increased uncertainty as to whether CFIUS might seek to impose significant measures to mitigate potential national security concerns in a manner that might materially impact the structure of the transaction.

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

There is enhanced scrutiny by CFIUS of transactions involving non-U.S. investors and U.S. businesses that operate in industries that are deemed to be sensitive from a national security perspective. Transactions involving Chinese investors, in particular, are now subject to intense scrutiny by CFIUS. In addition, FIRRMA expanded CFIUS' jurisdiction to enable review not only of investments in which non-U.S. investors might be acquiring control over U.S. businesses (which have always been subject to CFIUS review), but also certain investments in which non-U.S. persons would gain certain rights involving appointment of directors, access to material non-public technical information, or other substantive decision-making board appointment rights even in the absence of control. Investments by non-U.S. entities that are partially or wholly owned by non-U.S. governments also are subject to heightened scrutiny and might trigger mandatory filing requirements. There are exceptions, however, for certain PE investments made through partnerships in which the general partner is a U.S. entity or is domiciled in an "excepted state" (which currently includes Australia, Canada, and the United Kingdom).

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

The scope, timing and depth of legal due diligence conducted by PE sponsors in connection with acquisitions depends on, among other things, the transaction size, the nature and complexity of the target's business and the overall transaction timeline. Sponsors may conduct certain diligence in-house, but outside counsel typically handles the bulk of legal diligence. Specialized advisers may be retained to conduct diligence in areas that require particular expertise.

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

PE buyers and counsel will evaluate the target's risk profile with respect to anti-bribery and anti-corruption legislation, including the Foreign Corrupt Practices Act ("FCPA"). The risk profile depends on, among other things, whether the target conducts foreign business and, if so, whether any of the business is conducted (i) in high-risk regions (e.g., China, India, Venezuela, Russia and other former Soviet countries and the Middle East), (ii) with foreign government customers, or (iii) in industries with increased risk for violations (e.g., defense, aerospace, energy and healthcare). Diligence will be conducted based on the risk profile. Possible violations identified need to be thoroughly evaluated and potentially self-reported to the relevant enforcement authorities.

The DOJ may impose successor liability and sanctions on PE buyers for a target's pre-closing FCPA violations. PE buyers typically obtain broad contractual representations from sellers regarding anti-bribery and anti-corruption matters and often insist on compliance enhancements to be implemented as a condition of investment.

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

Fundamentally, under U.S. law, businesses operated as legally recognized entities are separate and distinct from owners. Consequently, PE sponsors generally will not be liable for acts of portfolio companies. However, there are several theories under which "corporate" form will be disregarded. These include:

(i) Contractual liability arising to the extent the PE sponsor has agreed to guarantee or support the portfolio company.

(ii) Common law liability relating to (a) veil piercing, alter ego and similar theories, (b) agency and breach of fiduciary duty, and (c) insolvency-related theories. Most often, this occurs when the corporate form has been misused to accomplish certain wrongful purposes or a court looks to achieve a certain equitable result under egregious circumstances.

(iii) Statutory control group liability relating to securities, environmental, 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



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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. PE sponsors who exercise actual and pervasive control of a portfolio company's facility by actually involving themselves in the portfolio company's daily operations, including environmental activities, may be exposed to liability as an operator of such facility. Parents can also have indirect or derivative liability for the portfolio company's liability under CERCLA if there is a basis for veil piercing.

Under the Employee Retirement Income Security Act ("ERISA"), when a subsidiary employer terminates a qualified defined benefit pension plan, all members of the subsidiary control group become jointly liable. Control groups arise among affiliates upon "the ownership of stock possessing at least 80% of total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of stock of such corporation."

ERISA imposes joint and several liability on any person who, upon termination of a plan, is a contributing sponsor of the plan or a member of the person's controlled group. As a result, all affiliated companies (including the PE sponsor and other portfolio companies) may face liability when an inadequately funded plan terminates, provided that the 80% control test is satisfied.

## 11 Other Useful Facts

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

Contract law in the United States embraces the freedom to contract. Absent public policy limits, PE sponsors in U.S. transactions are generally able to negotiate and agree upon a wide variety of transaction terms in acquisition documents that satisfy their underlying goals.

Transaction parties should expect increased regulation in the United States. In particular, new regulations should be expected in the arenas of cybersecurity and protection of personal data (both at the federal and state level) that will affect both how diligence is conducted and how portfolio companies operate. Taxes continue to be a key value driver in PE transactions, with IRRs and potential risks depending on tax considerations. See section 9.

Increased attention must be paid to potential CFIUS concerns, particularly given recent reforms and the political climate. Non-U.S. PE investors should be aware that investing in a U.S. business might trigger mandatory filing requirements. Even if a filing is not mandatory, it nonetheless may be advisable to submit a voluntary filing in order to avoid deal uncertainty, as CFIUS has the ability to open a review even after closing has occurred and could even require divestment. CFIUS considerations will remain a key issue for PE sponsors regarding foreign investments in 2020. See section 10.

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**John LaRocca** practices primarily in the areas of PE, M&A, carve-outs and alternative investments. He has represented a wide range of PE and corporate buyers and sellers in both domestic and cross-border transactions across various industries, including healthcare, manufacturing, chemicals, consumer products and retail. Mr. LaRocca has been ranked among the top PE buyouts lawyers in the United States by *Chambers USA*, where he is recognized for having "excellent judgment" and "knowing exactly when to be more flexible and when to stand firm". He has been listed as a top lawyer for PE buyouts in *The Legal 500 (U.S.)*, which noted his "very good business-sense". Particularly interested in working capital and complicated purchase price and waterfall mechanics and alternatives, Mr. LaRocca served as a certified public accountant and senior accountant with Price Waterhouse prior to joining Dechert.

**Dechert LLP**
Cira Centre, 2929 Arch Street
Philadelphia
PA 19104-2808
USA

Tel: +1 215 994 2778
Email: john.larocca@dechert.com
URL: www.dechert.com

**Dr. Markus P. Bolsinger**, co-head of Dechert's PE practice, structures and negotiates complex transactions – domestic and transatlantic M&A, leveraged buyouts, recapitalizations and going-private transactions – and advises on general corporate and corporate governance matters. Dr. Bolsinger's experience extends across industries, including healthcare, industrial, packaging, agribusiness, consumer, food and beverage, and restaurant sectors. His clients have included leading PE firms, such as First Atlantic Capital, ICV Partners, J.H. Whitney & Co., Morgan Stanley Capital Partners and Ridgemont Equity Partners. In addition to his core M&A and PE experience, Dr. Bolsinger has extensive expertise in transactional risk insurance, and frequently speaks and writes on the topic in major media outlets.
He has been listed as a recommended lawyer by the U.S., EMEA and Germany editions of *The Legal 500*, a legal directory based on the opinions of clients and peers. Recognized for M&A and PE buyouts, Dr. Bolsinger has been cited as "a trusted adviser" who "takes the time to understand a client's business and motivations before undertaking any way". Since 2010, every year Dr. Bolsinger has been recognized and received a *pro bono* service award.

**Dechert LLP**
Three Bryant Park, 1095 Avenue of the Americas
New York, NY 10036-6797, USA /
Skygarden, Erika-Mann-Straße 5
Munich 80636, Germany

Tel: +1 212 698 3628 / +49 89 2121 6309
Email: markus.bolsinger@dechert.com
URL: www.dechert.com

**Allie M. Misner** focuses her practice on corporate and securities matters. Ms. Misner represents private equity sponsors and their portfolio companies as well as strategic buyers and sellers in M&A transactions across a wide range of industry sectors. She also has experience representing companies and investment banks in domestic and cross-border securities offerings of equity and debt. In addition, Ms. Misner advises clients on general corporate matters, including corporate governance and public company reporting issues.
Ms. Misner currently serves as a member of the Executive Committee of the Business Law Section of the Philadelphia Bar Association and is a past co-chair of the Private Equity & Venture Capital Committee of the Philadelphia Bar Association.

**Dechert LLP**
Cira Centre, 2929 Arch Street
Philadelphia
PA 19104-2808
USA

Tel: +1 215 994 2449
Email: allie.misner@dechert.com
URL: www.dechert.com

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