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8TH EDITION

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# International Comparative Legal Guides

# Private Equity 2022

## Eighth Edition

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



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## Expert Analysis Chapters



## Q&A Chapters

# Preface

We are privileged to have been invited to introduce the 2022 edition of *ICLG – Private Equity*, one of the most comprehensive comparative guides to the legal aspects of private equity transactions available today. The *Guide* is in its eighth edition, which is itself a testament to its value to practitioners and clients alike. Dechert LLP is delighted to continue to serve as the *Guide*'s contributing editor.

With today's rapidly changing macroeconomic, social and political developments, it is critical to maintain an accurate and up-to-date guide regarding legislation and practice across a variety of jurisdictions. The 2022 edition of this *Guide* accomplishes that objective by providing global businesses leaders, in-house counsel, and international legal practitioners with ready access to essential information regarding the legislative framework and practice for private equity transactions in 25 different jurisdictions. This edition also includes two expert analysis chapters, which discuss pertinent issues affecting the private equity industry, transactions and legislation.

The eighth edition of the *Guide* serves as a valuable, authoritative and up-to-date source of reference for those seeking information regarding the procedural laws and legal aspects of private equity transactions, provided by experienced practitioners from around the world.

**Dr. Markus P. Bolsinger & Christopher Field**
**Dechert LLP**

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# 2022 and Beyond: Private Equity Outlook for 2023


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## Introduction

The global private equity (PE) industry, riding a years-long boom in dealmaking that slowed only slightly at the onset of the COVID-19 pandemic on its way to a record-setting 2021, has remained resilient through the first half of 2022, despite oncoming economic headwinds. Though off its 2021 pace, PE deal activity by both U.S.-based and European sponsors in early 2022 remained in line with historical trends in terms of deal value and as a percentage of overall M&A activity, mostly buttressed by large-cap PE dealmaking. While global PE fundraising weakened in the first half of 2022 compared to 2021, fundraising in the U.S., particularly for buyout funds, kept pace with previous years, as PE returns currently represent a more attractive opportunity for investors than public equity markets do. Nevertheless, rising interest rates, surging inflation, the ongoing war in Ukraine, choked supply chains and the growing expectation of a looming recession have begun to take their toll on deal volume, with sponsors turning their attention to strengthening their existing portfolio companies over searching for new platforms.

The rapidly changing economic environment is also spurring a rise in general partner ("GP") -led secondary transactions, a creative strategy for GPs to extend the life of existing PE funds rather than being forced to exit investments on pre-set deadlines. Carveout transactions and deepening involvement by PE funds in private credit can also be expected to feature prominently in the second half of 2022 and into 2023. At the same time, distressed deal flow has been slower than expected coming out of the pandemic, though it may yet quicken if global political uncertainty and adverse macroeconomic conditions persist. Tougher antitrust regulation around the world, combined with government sanctions, unavoidable supply chain issues, inflation and interest rate rises may spur more forced sales and other portfolio restructurings. Creativity and agility are therefore key for PE sponsors, both to identify and win investments in a competitive market and to create value post-acquisition.

## Trends in the PE Market

### GP-led secondary transactions

In a secondary transaction, an investor sells its partnership interest to another investor, the secondary buyer. If the seller is a limited partner, its sale of its limited partnership interest is known as an "LP-led secondary transaction". By contrast, a "GP-led secondary transaction" is a sale of one or more portfolio companies by a fund to another fund set up by the same GP to hold those portfolio companies. The new fund set up by the GP will be underwritten by new lead investors and is referred to as a "Continuation Fund".

Since 2016, GP-led secondaries as a proportion of all secondary transactions have risen from under 30% to a majority. Market disruption caused by COVID-19 was a significant catalyst for this change, with GPs being forced to turn their attention from value-creation to value-preservation of portfolio companies. At the same time, significant value-creation opportunities presented themselves to funds coming to the end of their lives (particularly those formed in 2013–14), yet fixed fund terms acted as arbitrary deadlines by which GPs had to realise profitable exits. Furthermore, high-quality assets in the market have been at all-time high prices, motivating GPs to search for means to retain their best-performing, highest-growth-potential portfolio companies, rather than pay premiums in the market. A solution becoming increasingly common in the market is to form Continuation Funds led by existing GPs. The market for GP-led secondaries has already matured to the point that representations and warranties insurance – a product more commonly associated with M&A deals – is now available for GP-led secondaries as well.

### Sustainability in PE

Sustainable investing has steadily risen over the last several years as a front-of-mind concern for investors, operating companies, consumers, employees, and regulators, having now reached a tipping point in which other market players, not within the scope of legislation or regulation themselves, are placing primary emphasis on environmental, social and governance (ESG) issues.

The EU has been the vanguard for regulating in this space, with its key aim of steering money flowing through the financial system towards sustainable activity. In this regard, the EU Action Plan on Sustainable Growth, the Sustainable Finance Disclosure Regulation (SFDR), and the Taxonomy Regulation have apparently had a desired dual effect. First, as they have begun coming into effect, with further key compliance dates in 2023, they have started a trend, inspiring comparable regimes across the globe. In the U.S., the SEC, in March 2022, proposed long-anticipated and comprehensive climate-related disclosure rules, and followed such proposal up in the ensuing months with specific rule proposals aimed at investment advisers and funds concerning ESG investment practices.

The second effect is that not only are those within scope of the disclosure regulations focusing heavily on ESG concerns, but those needing to attract investment and who, at least for the moment, are not in scope of the regime, are focusing on ESG as well. Both corporates and GPs are increasingly realising that making it easier for market participants to accurately assess the sustainability of an investment makes the investment commensurately more attractive.

PE firms are now focusing on ESG issues not just to increase current return potential (such as, for example, creating value by decarbonising a portfolio company), but also for reasons of weighting risk and future-proofing. Investors are recognising that future investors and consumers are increasingly likely to make business and spending decisions with an eye toward their environmental impact. Firms equally want to avoid allegations of greenwashing that arise from a lack of seriousness about sustainability, as well as unanticipated costs of ESG mitigation.

Given the nascent stage of most ESG-driven regulation, their success in driving results will be iterative. Areas for improvement include harmonisation across regulatory regimes and granular clarity as to what needs to be disclosed under the regimes. In addition, the veracity and availability of sustainability data needs significant improvement, together with harmonisation of the ways in which that data is created and treated. It is also clear that an increase in resource capability for data-handling is needed.

### Take-private transactions

The bear market in public equity markets has created buying opportunities for sponsors seeking new investment opportunities. This dynamic has already been reflected in 2022, with PE firms spending a record $226.5 billion globally on take-private transactions in the first half of 2022, up nearly 40% over the first half of 2021, and $117 billion on U.S.-based take-privates, up 72% from a year earlier, according to media reports. The same phenomenon has been taking place in Europe, where take-private transactions involving PE firms nearly doubled to $78 billion, up from $40.7 billion in the first half of 2021. Sponsors have also been active in the large-cap space, signing 10 deals for leveraged buyouts of U.S. public companies in deals valued at $5 billion or more, for an aggregate deal value of nearly $90 billion.

The disproportionate involvement of PE firms in take-private transactions reflects an alignment of incentives between sponsors seeking value and public companies struggling to meet market expectations under the weight of rising costs for labour and materials. Sponsors also found the market for debt financing to have still been relatively open in early 2022, a factor unlikely to remain in place for at least the near term.

### Carveout transactions

Carveout transactions are where corporates sell off, or "carve out", only part of their business or assets, either via a sale of a subsidiary or division or following reorganisation under which various non-core assets are transferred into a newly formed entity. There has been a marked increase in this form of transaction in the last couple of years; as economic and trading conditions remain uncertain globally, that trend may continue into 2023. Reasons for such divestments include paying down additional debt taken on during COVID-19, streamlining businesses, complying with increased regulatory and antitrust requirements (through divestiture itself or to meet fines), navigating restrictions on foreign investment, and additional costs of doing business in certain markets.

On the buy-side there is appetite for such sell-offs from cash-laden PE funds competing for opportunities to invest, employing buy-and-build strategies and identifying synergies in their existing portfolio. Carveout transactions often present a greater degree of complexity than platform deals, but can offer PE investors real potential for returns, given that target assets and businesses in carveouts frequently have untapped potential without having received sufficient attention or capital investment as part of a diversified operation. The chance to unlock this potential is particularly manifest when the target is a good fit with the buyer's existing portfolio companies, helping unlock synergies and creating a cleaner transfer requiring no, or minimal, transitional services arrangements.

### Private credit

The rise in use of private credit was fuelled during the 2008 financial crisis, when changes to regulation led to a lower risk appetite by traditional banks. This trend has continued through the more recent years of disruption, volatility and uncertainty in the market. With private credit proving increasingly popular for its relative speed, certainty, flexibility, bespoke solutions-based approach, and confidentiality, and now with record levels of fundraising as investors seeking higher returns put their money into private credit, larger and larger deals have been financed by credit funds. This is in step with the PE trend of closing increasingly large deals, as discussed above. The best evidence of private credit's popularity in the PE space may be found among EMEA-based sponsors, a majority of whom prefer private credit over traditional bank financing for their buyouts, according to a recent Dechert survey.

With this mainstreaming of private credit comes increased competition, given the pools available for investment, the arrival of new entrants, and traditional banks seeking more involvement in the space. Indeed, just as PE funds are finding a challenge in choosing among attractive assets in which to invest, so will private credit be jostling for the right deals to fund. As such, a willingness to take more risk and be more flexible in order to secure an investment can be expected. At the same time, having borne a level of risk that traditional banks post-2008 chose to avoid, the private credit system may find navigating the combined headwinds of high inflation, a potential recession and rising interest rates particularly challenging.

## Outlook

Despite the signals of an oncoming economic downturn in the second half of 2022, as long as public equity markets remain in correction territory, investors' appetites for PE opportunities can be expected to continue. PE firms' success in attracting funds will therefore need to be matched with successful investment opportunities. Not surprisingly, auctions have become increasingly competitive, making it essential for sponsors to be fast, flexible and decisive. Alternative deal structures, the use of private credit and greater diversity in investments are becoming permanent fixtures of the PE landscape, as apparent in the rise in GP-led secondaries, take-privates, and carveout transactions.

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**Harriet Cahalane**, **Helen Collip** and **Daniel Rubin**, professional support lawyers at Dechert LLP, all contributed to this chapter.

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Dechert has been at the forefront of advising private equity firms for 35+ years. With more than 300 private equity 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 private equity lawyers advises private equity, private credit and other alternative asset managers on flexible solutions at every phase of the investment life cycle.

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# When an Exit Isn't Quite an Exit – the Rise of Continuation Funds in M&A


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"*Some things are hard to let go of.*" **Veronica Roth**

## Introduction

Like the global financial crisis more than a decade ago, the COVID-19 pandemic and its aftermath, as well as other crises in 2022, have created significant distortion in the market for private equity portfolio assets.

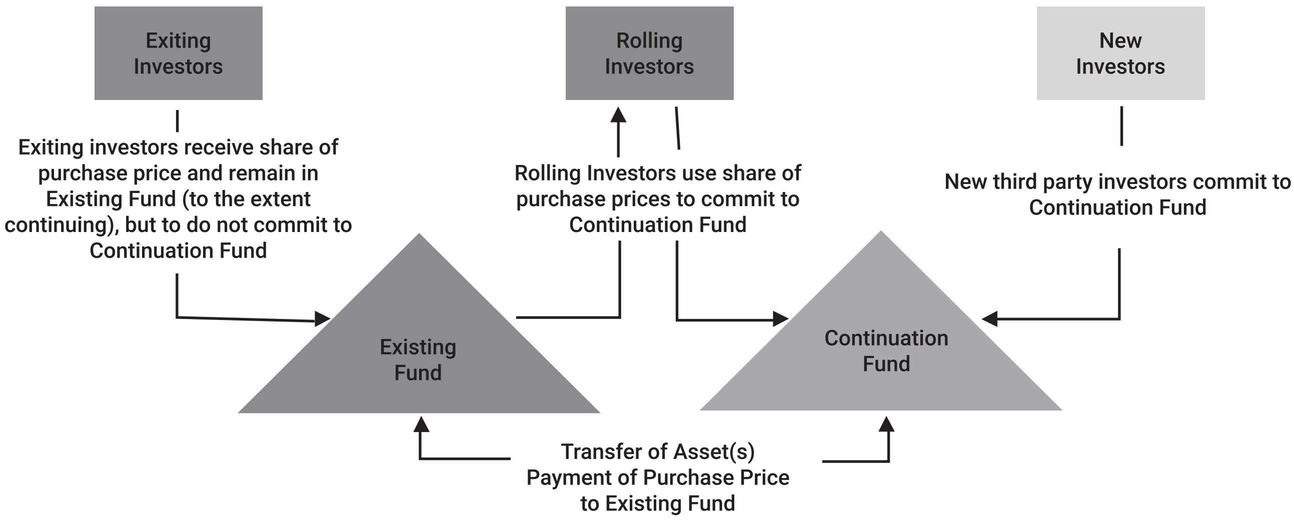
Where the relevant asset's business was "COVID-friendly" or had otherwise enjoyed an upturn as a result of the pandemic (e.g., those businesses in the remote service delivery or domestic electronic goods sectors) this distortion has presented private equity houses with an opportunity to realise unexpected upside. However, in a significant number of cases, private equity sellers have found that the pandemic has thrown a spanner in the works both in terms of scheduled exit windows and what valuations may be achievable.

Against this backdrop, private equity houses have increasingly turned to the "continuation fund" as means of extending an asset's hold period so that its optimum value may be realised at a later date while also offering liquidity to those investors that need it in the short term.

The tool of continuation fund transactions or fund-to-fund transactions (involving a complete exit by existing funds holding the asset and a purchase by new funds or vehicles, but with the same manager or general partner ("GP")) was already becoming popular with private equity funds seeking to realise returns, but to retain the upside of the next round of investment and not simply pass a well-liked asset to someone else to make money. We will in this chapter focus on continuation fund transactions as opposed to fund-to-fund sales.

This chapter will also explore some of the key features of continuation fund structures while highlighting some of the trickier issues fund managers should be aware of when considering their implementation.

## 1. The Continuation Fund




The term "continuation fund" (in this chapter "Continuation Fund") is a catch-all expression; however, in broad terms they can be described as new fund vehicle(s) established to acquire assets from an earlier fund (the "Existing Fund") usually managed by the same manager or GP. Investors in the Existing Fund will be offered the opportunity to realise value at the point of the sale to the Continuation Fund (the "cash out" option) or to roll that value into the new, longer horizon, Continuation Fund (the "rollover" option). Frequently, investors will opt for a combination of both approaches.

New investors in the Continuation Fund will make up the deficit in the equity valuation of the asset(s) being sold to the Continuation Fund and/or increase the equity commitment for the next round – for example, for a buy-and-build. Both the new investors and the "rollover" investors may provide further additional capital for bolt-on investments or capex at asset level.

In addition to facilitating a longer hold period that may be beneficial from a valuation perspective, Continuation Fund structures allow the fund GP/manager to benefit from continued management fees and (potentially) a greater realisation of carry.

Existing investors will benefit by being offered liquidity in advance of when the open market may be able to provide it, as well as the opportunity to commit capital to a known asset for a longer period if desired – not giving up the future growth.

## 2. Key Legal Considerations

### General considerations

At the outset, the Existing Fund's constitutional documents should be reviewed to determine whether any level of investor/limited partner advisory committee ("LPAC") review is required with respect to any Continuation Fund structure (e.g., conflicts of interest, related party clauses). Early limited partner ("LP") consultation is, of course, good investor relations, and some consents or approvals may be prudent even if a conclusion can be reached that they are not specifically or strictly required. In a similar vein, asset-level documentation should be checked for any pre-emption or tag-along rights that may restrict a clean sale to a Continuation Fund.

From regulatory perspective, it is important that the GP/manager must ensure that both new and existing investors are treated fairly and that full and credible consideration has been given to other exit avenues.

### Valuation

One of the key potential conflicts of interest that will require particularly careful management is the competing interest of the Continuation Fund to buy at a low price, and that of the Existing Fund to realise at a high price.

To seek to manage any actual or perceived conflicts of interest in relation to the issue of price, it is of paramount importance that a transparent and rigorous valuation process is followed. The appropriate valuation mechanism will vary depending on prevailing market conditions and the asset in question. However, examples of appropriate pricing methodologies include:

- the determination of an independent expert as to what FMV should be;
- a book-building process; and/or
- the invitation of bids following the circulation of an IM.

There is some anecdotal evidence in the market that investors are beginning to challenge Continuation Fund processes (and fund-to-fund processes as well) where they do not consider that a rigorous valuation or broader process has been followed. Unsurprisingly, the trend is particularly acute where an investor has "cashed out" and the asset's valuation increases significantly during the tenure of ownership of the Continuation Fund. For this reason alone, managers should ensure they are able to robustly justify the transfer valuation if challenged.

### Terms of the asset transfer

In addition to the terms customarily included in a sale and purchase agreement ("SPA"), an SPA on a Continuation Fund transfer may include specific provision for pricing adjustments in view of the "record date" of the transaction and provide for the escrow of proceeds due to the Existing Fund as a means of providing comfort to new investors.

On the subject of liability and risk management, it is worth flagging that it will likely be more challenging to secure warranty & indemnity ("W&I") coverage on a Continuation Fund sale. While W&I is now a feature in the overwhelming majority of private equity sales, Continuation Fund structures obviously present unique concerns from an underwriting perspective. That said, these issues are not always insurmountable and – where a rigorous sale process has been run and appropriate diligence conducted – coverage may be available in the market (albeit policy pricing may reflect the greater level of perceived risk).

Warranties and (where appropriate) indemnities are also important to the management of conflicts of interest and being able to demonstrate their thoughtful provision/negotiations is important. For lawyers, bar rules or professional conduct points must also be addressed as necessary.

## 3. Conclusion

While Continuation Fund structures have undeniably proved to be a useful and successful tool for both investors and managers in recent times, they do present a number of unique challenges from investor relations, legal, regulatory and management perspectives. Fund managers considering these structures should seek specialist advice early to ensure that any sales process is appropriately robust and that – so far as possible – relationships with existing investors and incoming investors are enhanced rather than damaged.

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

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

Sidley has more than 2,000 lawyers in 20 offices in key business and financial centres around the globe and is proud to serve clients across the entire spectrum of legal services. Sidley lawyers pride themselves on being the trusted counsel of choice for their clients most complex and crucial matters and on talent, teamwork and results for over 150 years. Sidley's team recently won Private Equity Team of the Year at the 2021 Legal Business Awards in London.

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# Austria


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## 1 Overview

**1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?**

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, specialist debt funds have become increasingly active over the last years, not only in the large-cap (buyout) segment. These days, debt funds offer all sorts of instruments, ranging from growth capital, stressed financing, 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 and developing, we have seen this becoming a lesser issue over the last couple of years. However, this has again changed in recent months due to the war in Ukraine.

**1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

So far, the COVID-19 pandemic has not resulted in such significant distressed situations that were anticipated by many large-scale international special situations funds. The broader consensus is that this is due to the various government support programmes, which managed to stabilise most parts of the economy.

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

We have seen a significant increase 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 invest in the long term and put less focus on exit provisions. Their entrepreneurial background often gives them a competitive advantage in auctions where family-owned businesses are up for sale.

## 2 Structuring Matters

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

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

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

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

With regard to taxes, the main argument for Austrian multilayer HoldCo and BidCo structures was the availability of goodwill amortisation on share deals and that capital tax on capital contributions could be avoided through indirect parent contributions; neither have any relevance anymore. Austrian HoldCos and BidCos can, however, still enter into a tax group with the target company. This allows for a set-off of interest expenses at the HoldCo and BidCo levels with the taxable profits of the target company (for a more detailed discussion, please see questions 9.1 and 9.4).

### 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 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). 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 and conflicts of interest, veto rights of the fund (and/or the sponsor representative) (see question 3.2), dilution protection for the fund, a liquidation preference for the fund, restrictions on dealings with shares (typically including a lock-up, rights of first refusal, tag-along, and drag-along rights), exit rights for the fund (via a trade sale, an initial public offering ("IPO") or a shotgun mechanism) as well as reporting, information and access rights.

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

To the extent the above arrangements are included in the articles of association (which has some benefits for some (but not all) of them from an enforcement perspective (see question 3.3)), they are publicly accessible through the companies register. In addition, certain arrangements may have to be disclosed under Securities Law disclosure requirements.

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

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

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

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

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

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

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

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

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

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

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

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

**Restrictions**

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

**Requirements**

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

**Risks and liability**

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

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

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

Where a sponsor nominee director has a conflict of interest 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 one proceedings (if no exemption is granted) and up to five months if cleared in phase two proceedings);
- regulatory clearance (e.g. the acquisition of a qualified or controlling interest in the banking, insurance, utilities, gambling, telecoms or aviation sector is subject to advance notification or approval of the competent regulatory authority);
- real estate transfer clearance (the acquisition of title and certain other interests in real estate by non-EEA nationals, or control over companies holding such interests, is subject to advance notification or approval (depending on state law)); and
- clearance pursuant to the Investment Control Act (*Investitionskontrollgesetz* – "*InvKG*") (the direct or indirect acquisition of voting rights (thresholds vary depending on the sensitivity of the sector) or an (otherwise) controlling interest or of material assets of a business involved in certain protected industries by a non-EEA or non-Swiss national is subject to approval of the Federal Ministry for Digital and Economic Affairs. Micro-enterprises with fewer than 10 employees and an annual turnover or balance sheet total of fewer than 2 million are exempt).

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

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

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

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

## 5 Transaction Terms: Public Acquisitions

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

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

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

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

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

In public acquisitions (that is, transactions involving a public takeover bid) where the target company would have to pay, they are sometimes discussed but they are not common as there is little guidance as to what extent they would be valid. 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 seller's warranty and indemnity insurance or offer the buyer management warranties instead (then usually linked to buyer's warranty and indemnity insurance). The latter option has the benefit that the private equity fund need not concern 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?

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

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

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

Common limitations on warranties include:

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

**Qualifying warranties by disclosure**

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

**Limitations on indemnities**

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

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

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

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

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

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

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

## 7 Transaction Terms: IPOs

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

An IPO exit requires that the articles of association and by-laws be adjusted, due diligence performed and a prospectus prepared.

In addition, the company will have to enter into an underwriting agreement and management will have to participate in road shows. All of that requires the cooperation of the company and (at least) where no new shares are issued and the management will typically ask the private equity seller to bear most of the associated costs (based on an argument related to capital maintenance rules). Any new shares issued in the IPO will naturally limit the number of shares the private equity seller can sell into the IPO. In addition, the underwriting agreement will usually provide for lock-up restrictions (see question 7.2) that limit the private equity seller's ability to sell any shares it has retained following the IPO. Finally, the private equity seller will usually be asked to give warranties in the underwriting agreement. In most cases, the private equity seller will be able to limit those warranties to matters relating to the private equity fund and the shares it sells into the IPO. Sometimes, director nominees are also required to give warranties in the underwriting agreement.

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

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

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

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

### 7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?

Thus far, special purpose acquisition companies ("SPACs") have not played a role in Austrian IPO or M&A markets.

## 8 Financing

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

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

In mid- and small-cap transactions, there is usually just senior and institutional debt. On large-cap transactions, it is a matter of pricing whether mezzanine is applied. A high yield is typically only considered for post-completion refinancing but not for the financing of the transaction. Generally, recent deals show a noticeable increase in financing provided by debt funds.

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

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

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

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

## 9 Tax Matters

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

Usually, the private equity fund will seek to implement a tax offset structure to offset interest expense at the Austrian BidCo level with profit generated at the target company level (however, see question 9.4 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, in relation to funds acting as lenders, such disclosure rule may be burdensome to comply with.

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

Avoidance of withholding taxes on dividends is usually less of an issue, since pre-exit distributions are very rare. Still, to address that issue, EU entities are usually preferred over non-EU entities and, among the latter, entities from non-EU countries with which Austria has concluded a double taxation treaty over entities from other non-EU countries. In such structures, we also see an increased level of substance (in terms of own premises and personnel) in the foreign entities, which then usually provide internal services to related entities.

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

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

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

An exchange of shares is treated in the same way as a sale of shares and thus triggers capital gains taxation. In a typical case, where the management only holds a small stake in the target company, the only option to roll-over into a new structure without triggering capital gains taxation is a contribution (*Einbringung*) under the Reorganisation Tax Act (*UmgrStG*) of their shares into a holding, which thereby acquires or enlarges an already existing majority holding in the target company. Recently, the rules for individuals applicable to such transactions in a cross-border context have been adopted to expand the options for managers to avoid taxation upon the roll-over.

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

**Corporate income tax rate**

As part of the "eco-social" tax reform package, the corporate income tax rate will drop from 25% to 24% for FY 2023 and to 23% as of FY 2024. 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.

## 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?**

**FDI – Clearance**

In July 2020, the Investment Control Act ("ICA") came into force, which requires advance clearance for certain foreign direct investments by investors from outside the European Economic Area or Switzerland. Direct and indirect acquisitions of: (i) voting rights of 25% or 50% (in critical sectors 10%); (ii) a decisive influence in an Austrian company; or (iii) significant assets in sensitive sectors such as defence, energy, digital infrastructure, R&D, but also IT, public transport, health, telecommunications, chemicals, robotics, semiconductors, nuclear and biotechnology, food supply, supply of pharmaceuticals, vaccines, medicinal products and media, which are considered to be of critical importance for security and public order in Austria, will require approval by the Austrian Ministry of Digital and Economic Affairs. Exempt from the approval requirement are foreign direct investments in micro-enterprises, including start-ups with fewer than 10 employees and an annual turnover or balance sheet total of fewer than 2 million. Approval may be granted subject to certain conditions. An investor failing to obtain approval before closing may face administrative and even criminal sanctions. In addition, an investment is deemed void until approval has been obtained. Since the investment control proceeding will take between two-and-a-half months in simple cases and five to six months in more complex cases, the transaction documents should provide for sufficient time between signing and closing. In specific cases, it may be worthwhile to apply for a clearance certificate which would be issued more quickly.

**Fund Regulatory**

As one of the last EU Member States, Austria implemented Directive (EU) 2019/1160 (which modifies the UCITS Directive and AIFMD) in December 2021, which aims to facilitate and harmonise cross-border distribution of funds across the European Union.

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

With regard to regulatory scrutiny over private equity funds, please see question 10.1. 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).

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

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

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

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

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

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

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

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

## 11 Other Useful Facts

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

In the recent past it was sometimes difficult for private equity investors to access Austrian businesses, in particular 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 foreign direct investments by non-EEA/non-Swiss investors in sectors qualifying under the ICA (see question 10.1) and typically requires the transaction to be notified. Clearance typically takes approximately three months, which must be taken into account in the overall timing of transactions. Notifications can be made on the basis of preliminary documentation (such as a term sheet or a memorandum of understanding).

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

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Schindler Attorneys is a leading Austrian law firm focused on transactional work, with a strong focus on private equity. The members have an impressive private equity track record and an excellent understanding of the needs of financial sponsors. The firm's integrated tax practice is a key differentiator from other firms 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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# Bermuda


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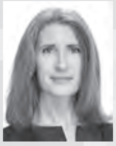

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## 1 Overview

**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?**

Private equity investment in Bermuda largely originates from the United States, Canada and Europe and, as fund managers are typically located in these jurisdictions, Bermuda's private equity transactions will follow the investment trends of major onshore markets. Bermuda is seeing an increasing trend in private equity investors taking stakes in Bermuda insurers and reinsurers, whether in new ventures or in participation in the insurance business consolidation and runoff. This trend is not surprising given Bermuda's position as the world's premier offshore insurance and reinsurance jurisdiction.

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

Bermuda is recognised as a premier offshore jurisdiction for domiciling private equity groups. Bermuda's robust and dynamic legislative and regulatory framework, common law legal system offering familiarity to UK and US investors, political stability, tax neutrality, OECD whitelist designation, choice of flexible structures that are easily set up, experienced service providers, proximity to major financial centres and favourable time zone together make Bermuda an attractive domicile of choice.

The Bermuda Monetary Authority (BMA), the regulatory body responsible for Bermuda's financial services sector, proactively consults with industry regarding its needs and the development of new laws and regulation. This has proven critical in establishing and maintaining a healthy relationship between business, government and the regulator and in fostering the continued development of robust industries including private equity. Collaboration between the BMA and the industry has been most recently evidenced by the enactment of legislation providing for the incorporation of incorporated segregated accounts companies (facilitating the establishment of separate cells or sub-funds with separate legal personality), and legislation supporting the incorporation and regulation of fintech-related businesses. Such legislative changes are addressed, along with others, in greater detail in response to question 10.1 below.

**1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

While the long-term impact of COVID-19 on private equity in Bermuda will require more time to assess, we have seen an immediate impact of tightening of credit availability, completion dates being pushed out and break fees renegotiated. Having said that, the market turbulence resulting from COVID-19, along with hardening of rates in the insurance sector as a result of the estimated $100 billion of additional insured losses arising from the pandemic, have also presented opportunities in an area where private equity, understood to have a large volume of "dry powder", has recently shown much interest (see our answer to question 1.4 below). For example, a number of Bermuda insurers have engaged in significant capital-raising exercises to fund new acquisitions, presenting considerable opportunities, with Fidelis raising $800 million and RenaissanceRe $900 million, to name but two.

**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.**

Bermuda has witnessed a significant uptick in business involving private equity fund managers with a presence in the United States, Canada and Europe doing significant business in, or from, Bermuda, with Bermuda insurance and reinsurance companies. A large number of substantial private equity fund managers with a presence in the United States, Canada and Europe do significant business in, or from, Bermuda, such as Apollo Global Management and Onex Partners, which participate in the Bermuda insurance and reinsurance industry through companies like Athene Holding, Aspen Insurance and Convex Re. Athene Life Re's sidecar vehicle for life and retirement investment opportunities, Athene Co-Invest Reinsurance Affiliate, has recently raised $3 billion of capital. The Carlyle Group and Japan's T&D Holdings recently increased their holding of ex-AIG legacy reinsurance entity, Fortitude Re, to 76.6%. Runoff reinsurance also continues to be an area of interest for private equity, with Bermuda seen as an attractive domicile. 2019 saw Aquiline Capital Partners partner with others in a $500 million capital raise for Armour Group Ltd., a Bermuda-based property and casualty runoff acquirer, and Carlyle's stake in Fortitude Re as examples, not to mention investments in closed books of life business.

## 2 Structuring Matters

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

There is a broad choice of private equity vehicles in Bermuda, namely exempted companies limited by shares, exempted limited partnerships (LPs), limited liability companies (LLCs), segregated accounts companies, incorporated segregated accounts companies and unit trusts.

Private equity acquisition structures vary depending on whether the target entity is a privately or publicly held entity and whether the acquisition involves the whole, or only a minority position, of the target. For privately held Bermuda entities, acquisition may be by direct or indirect investment. Direct investment involves the issue of new shares (or partnership or membership interests or units) or the transfer of shares (or partnership or membership interests or units) to the private equity investors. Indirect investment structures typically involve the incorporation of an acquisition vehicle to acquire the target by way of share purchase, merger, amalgamation or share exchange. The acquisition vehicle may be the borrower under related debt facilities or other intermediary entities may be incorporated for such purpose or to accommodate other structuring needs of the acquirer, such as security arrangements and tax considerations.

Where the target is a listed entity, the acquisition structure may involve a merger or amalgamation, an offer to purchase the shares of the target, a compulsory acquisition, or a scheme of arrangement. The requirements for a merger or amalgamation are the same for private and public targets – generally, the boards of the respective companies must approve the merger or amalgamation agreement, and their respective shareholders must approve the merger or amalgamation agreement; such approval, for any Bermuda entities, being 75% of the shareholders present and voting at a special general meeting at which two or more persons are present in person or by proxy, unless the bye-laws provide otherwise. All shares have the right to vote in an amalgamation, including non-voting shares, and classes may be entitled to a separate vote if the merger or amalgamation agreement contains a provision that would constitute a variation of the rights attaching to any such class of share. Shareholders who do not vote in favour of the merger or amalgamation and who are not satisfied that they have been offered fair value for their shares may, within one month of the notice of the special general meeting, apply to court to have the fair value of their shares appraised.

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

Acquisitions structures are driven largely by onshore tax and commercial considerations, including requirements of lenders.

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

The structuring of equity in a private equity transaction varies but would typically involve private equity investors subscribing for shares (common and/or preference) and possibly being issued loan notes, and key management similarly subscribing for shares (common or another class) and possibly being issued performance-triggered share options.

Where the structure employs LPs, private equity investors will subscribe for partnership interests and, though less common, management may participate through a carried interest.

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

Taking a minority position will often necessitate the private equity investor to focus on protections that can be established in the bye-laws and shareholders agreements. Typical minority shareholder protections include voting rights (whether through unanimous, weighted, veto or voting thresholds or requirements), anti-dilution rights, drag-along and tag-along rights, director nominations or appointments, information rights, and change of control provisions.

### 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 allocation of equity to management would be in the range of 5–20%, but generally follows the trend of onshore markets.

Management's options would typically be subject to conditions tied in with performance and length of tenure, with options being exercisable on reaching targets and/or vesting on sale of the target within parameters. It would be expected that management shares would be subject to repurchase on termination of employment, with options being exercisable after employment termination depending on good and bad leaver scenarios.

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

What constitutes a good or a bad leaver will be agreed contractually rather than by reference to Bermuda employment laws. Bad leavers would include those who voluntarily resigned, breached non-competition or other covenants or were otherwise terminated for cause. Good leavers would include those leaving employment due to death, injury or retirement or any other reason that does not fall under the category of 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?

A Bermuda private equity portfolio company would be governed by its board of directors, typically composed of executive directors, investor-appointed directors and independent directors. In private equity transactions, a shareholders agreement (or investor rights agreement) would set out the rights of the investors and other shareholders (or a group of them) *vis-à-vis* each other and the company as regards, among other things, the appointment of directors and voting rights and thresholds. Neither the bye-laws nor the shareholders agreement are publicly available documents. However, due to changes to the Companies Act 1981 in 2018, certain provisions of the bye-laws are required to be filed with the Registrar of Companies (ROC), namely provisions on share transfer and registration of estate representatives, duties of the secretary and quorum requirements for general meetings. However, these filed bye-law provisions are not publicly available.

An LP is managed by its general partner (which need not be a Bermuda entity or resident) and the rights and obligations of the partners are largely agreed in the limited partnership agreement (LPA), rather than statutorily mandated. The LPA is not publicly available and is not required to be filed with the BMA or the ROC.

Bermuda's limited liability legislation was modelled on that of Delaware and, as such, a Bermuda LLC will share many of the same attributes, including the significant degree of flexibility when it comes to management and shareholder arrangements, that are agreed in the LLC agreement. A private equity portfolio company that is an LLC is afforded great latitude in its governance structure – it may be member-managed or non-member-managed. As with an LPA, the LLC agreement is not a public document, nor it is filed with the BMA or ROC.

### 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?

Whether and what veto rights a private equity investor will enjoy is a matter for negotiation in each transaction. It would not be usual to see veto powers (whether requiring the director or shareholder vote or requiring an agreed voting threshold be met whilst a benchmark shareholding is met) at a shareholder or director level regarding changes to share capital, debt, constitutional documents, the composition of the board or management, the nature of business and as regards anti-dilution (whether by the issue of new issues or share transfers), major acquisitions or dispositions and change of control.

Veto rights of limited partners are not typically seen where the private equity entity is an LP. In such cases, the general partner exercises its powers within the confines of the negotiated LPA.

### 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 Companies Act 1981 expressly provides that certain powers of the company reserved to shareholders can be fettered (including name changes, alteration of the constitutional documents, alteration of share capital and removal of directors). Fettering of the powers of the company reserved to shareholders in a shareholders agreement or investors rights agreement that go beyond those expressly permitted would not be upheld by a Bermuda court.

As noted in response to question 3.6 below, directors owe fiduciary and statutory duties to the company. Any purported fettering of the discretion of the directors and their ability to act in the best interests of the company in the bye-laws or a shareholders/investor rights agreement may not be upheld by a Bermuda court. To avoid such issues, voting and veto powers should, to the extent possible, be at the shareholder level in the shareholders agreement. Similarly, the general partner of an LP owes a duty of good faith and must act in the interests of the LP and not in the interests of one limited partner.

### 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?

Fiduciary duties are not owed by a private equity investor to minority shareholders under Bermuda law or *vice versa* (unless contractually agreed). Members have absolute discretion to exercise voting rights in their own sectoral interests, subject to limited exceptions relating to resolutions to approve and adopt modification and/or restatement of bye-laws, where resolutions to make such modifications or restatements can be attacked if shown to be of a type that no rational member could have approved.

### 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 limitations or restrictions on the contents or enforceability of shareholders agreements, save if contrary to public policy (noting, as provided above, it would not be permissible for a shareholders agreement to fetter the powers of the company beyond that expressly permitted in the Companies Act 1981). Shareholders agreements governed by the laws of other jurisdictions are similarly enforceable to the extent they are not illegal or contrary to Bermuda public policy. Non-competition and non-solicitation provisions are enforceable under Bermuda law provided the restraint is reasonable and necessary to protect the legitimate business interests of the private equity investor and reasonable as to other factors.

### 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 directors of a Bermuda company may be appointed or elected by a particular shareholder or shareholder group, they each owe a fiduciary to act in good faith (including a duty to avoid conflicts of interest) in dealing with or on behalf of the company, and a statutory duty to act honestly and in good faith with a view to the best interests of the company. Such duties are owed to the company as a whole, which includes all its shareholders. As such, directors cannot put the interests of the shareholder who appointed or elected them in priority to the interest of the company and need to be particularly mindful that their duties are owed to the company as a whole and not to the shareholders who nominated or appointed them. Similarly, where a director is a director for multiple companies of the same group, while a group benefit may be considered, he must nonetheless act in the best interests of each company he serves individually and not sacrifice any one such company's interests to those of the group as a whole.

The bye-laws of a Bermuda company would typically provide: (i) for the indemnification and exculpation of its directors and offices acting in relation to the affairs of the company and its subsidiaries, except in respect of any fraud or dishonesty; and (ii) that the company may purchase, for the benefit of its directors and officers, insurance in respect of losses arising out of a breach of their duty of care, diligence and skill or insurance indemnifying for losses in respect of negligence, default, breach of duty or trust. See also question 3.7 below regarding conflicts of interest.

The general partner of a Bermuda LP is responsible for managing the business of the LP and has a statutory duty to act in good faith and, subject to the express provisions of the LPA, in the interest of the LP. With amendments made to Bermuda's partnership legislation in 2015, members of boards and committees of an LP will have the benefit of indemnity and exculpation clauses in the LPA (unless such agreement states otherwise).

As the express intent of Bermuda LLC legislation is to give maximum effect to the principle of freedom of contract, considerable flexibility is permitted as regards managers' duties to the LLC. Such duties are agreed in the LLC agreement and to the extent, at law or in equity, a member, manager or other person has duties (including fiduciary duties) to an LLC or member, manager or other party to the LLC agreement, the LLC agreement may expand, restrict or eliminate such duties (except that the LLC agreement may not permit fraud or dishonesty). The LLC agreement may also provide for indemnity and exculpation provisions for its members and managers (except in respect of their fraud or dishonesty) and provide for the purchase of insurance for the benefit of its officers, members and managers for liabilities incurred in acting in such capacities. See question 3.7 below regarding conflicts of interest.

See also the response to question 10.5 below regarding situations giving rise to shareholders, member and limited partner liabilities.

**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 by the Companies Act 1981 to disclose, at the first opportunity, at a meeting of the directors (or by writing to the directors), his interests in any material or proposed material contract with the company or its subsidiaries and in any person a party thereto. Failure to disclose a conflict of interest can render the director liable to a fine of $1,000. Subject to the bye-laws, a director is not prohibited from voting on any matter in relation to which he has disclosed an interest.

The Bermuda LLC Act expressly permits members and managers to vote in their own self-interest even if not in the best interests of the LLC, unless otherwise provided in the LLC agreement. Where the private equity fund is an LP, an advisory committee may be established for the purposes of approving/disallowing 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?**

Bermuda offers an efficient, streamlined approach to incorporation, formation and organisation of private equity vehicles. The ROC and the BMA are the two regulatory bodies that approve incorporation or formation of private equity vehicles. Once submission of the required beneficial ownership information is complete, a company can be incorporated or a partnership formed in a matter of days.

For private equity funds that are closed-ended investment funds, please see the response to question 10.1 below, which addresses recent amendments to the Investment Funds Act 2006 of Bermuda (IFA) bringing within its scope closed-ended investment funds and overseas investment funds, requiring registrations or designation. Where the private equity vehicle is a closed-ended investment fund, the registration process can be prompt, although consideration should be given to the time required to prepare the application, which includes, among other things, a copy of the offering document complying with the IFA and details of the fund's service providers to satisfy the BMA that they are fit and proper persons.

There are no antitrust or foreign direct investment approvals to be obtained or filings to be made in Bermuda. The timetable for transaction could be impacted if the target is a regulated entity, such as a financial institution, investment business, regulated fund or insurance company where regulatory approvals or notification and confirmation of no objection may be required.

Unless a general permission of the BMA applies, all transactions involving the transfer or issue of shares to non-residents will first require the customary customer due diligence and vetting of the new ultimate beneficial owners. Once provided with satisfactory information, approval for the issue or transfer is typically a perfunctory matter.

Offers of securities to the public are subject to prospectus rules under the Companies Act 1981. However, it is often possible to disapply these on the basis that the offer can be certified on behalf of the board of directors as not calculated to result, directly or indirectly, in the shares becoming available to more than 35 people and, if greater, they are likely to have an offering document as a matter of course. Prospectus rules are also disapplied where the securities are to be listed on an "appointed stock exchange" (being a foreign stock exchange approved by the ROC).

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

Private equity transactions in Bermuda follow the trends in North America and Europe.

## 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?**

For the most part, Bermuda companies in privatisation transactions are likely to be listed on exchanges outside of Bermuda, so one would need to look to the particular exchange to ascertain the relevant features and/or challenges to the privatisation.

Bermuda does not have a takeover code. The rules of the applicable exchange (being the Bermuda Stock Exchange listing rules if the target is listed in Bermuda), the Companies Act 1981, any other applicable legislation (which will be dependent on the business of target company) and the constitutional documents of the target will all be relevant in a privatisation. Where the target is a public company, the transaction will be structured in one of the manners outlined in response to question 2.1 above.

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

Break fees and "no shop" provisions are available, provided the break fee is based on a genuine pre-estimate of compensation for losses and not a penalty, and with the "no shop" being subject to an exemption where necessary to permit directors to comply with their fiduciary duties in relation to a competing offer. Break fees tend to be in the range of 2–4% of the deal 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?**

Consideration is most commonly subject to a holdback for adjustments based on post-closing valuations of the target. The use of locked-box consideration structures is increasing.

**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?**

It would be expected that management provide the usual commercial warranties, and sellers push to limit their representations to title, capacity and authority, with knowledge and materiality qualifiers and short survival periods. Indemnification for losses resulting from breaches of representations and warranties are customary (to the extent not otherwise captured in post-closing adjustments), with trigger and cap thresholds.

**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?**

Sellers would be expected to provide pre-completion covenants to assist with any regulatory filings or approvals, and exiting management may be required to provide non-solicitation and non-compete covenants (see the response to question 3.5 above for further considerations on non-compete and non-solicitation clauses).

**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 representation insurance is seldom purchased in connection with Bermuda private equity transactions.

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

While negotiating terms, a seller may limit its liabilities under warranties, covenants and its indemnity by limiting their scope, employing knowledge qualifiers, restricting the period for claims, employing threshold amounts for triggering payment (whether for individual items or in the aggregate), and seeking an individual or aggregate 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)?**

No, it is not usual for sellers to provide security for warranties or liabilities. While warranty and representation insurance may be used in transactions, it remains a common approach for a portion of total consideration to be withheld and subject to adjustment based on post-completion adjustments to the value of the target, capturing losses resulting from breaches of certain warranties and/or covenants.

**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.)?**

Sellers obtain comfort as to equity or debt financing in the transaction agreement, be it a purchase or implementation agreement, whose obligations would become enforceable on the satisfaction of agreed conditions. Representations and warranties as to financing and/or comfort letters would also be customary.

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

While reverse break fees are seen in Bermuda transactions, their prevalence is deal-driven, with an increased prevalence in deals involving US investors.

## 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 offerings (IPOs) on the Bermuda Stock Exchange are not a common exit strategy for private equity transactions. If an IPO is the chosen exit strategy, it is more likely that the entity would be conducting an IPO on an onshore exchange and, as such, the rules of such exchange would be relevant. The BMA has given its permission for the issue and transfer of "equity securities" of Bermuda-exempted companies to and from non-residents of Bermuda where such company's equity securities are listed on an "appointed stock exchange". (An equity security is a share conferring the right to vote for or appoint a director (or security convertible into such a share) and there are 59 appointed stock exchanges, including NASDAQ, NYSE, the LSE and HKSE.)

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

The terms of lock-ups would be negotiated by onshore parties and, in particular, the underwriters, to the IPO. Private equity sellers should expect a lock-up on all or some of their shares for a period of approximately six months post-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?**

Private equity sellers seeking the highest return on their investment will generally pursue a dual-track exit.

**7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?**

Bermuda's amalgamation and merger procedures make it a favourable jurisdiction in which to implement the de-SPAC-ing process. The procedures are described in our answer to question 2.1.

## 8 Financing

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

Private equity investors are typically based outside Bermuda, as are their sources of financing transactions; it is necessary to look to onshore markets to understand the debt sources and state of finance in those markets.

**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, there are no legal requirements or restrictions impacting the nature or structure of debt financing in Bermuda.

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

As debt financing for private equity transactions is not typically obtained in Bermuda, there are no discernible trends to speak of.

## 9 Tax Matters

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

Private equity vehicles and their investors, shareholders, partners or unit holders, as the case may be, that are non-residents of Bermuda, are not subject to any tax computed on profits, income, capital assets, gains or appreciation or any tax in the nature of estate duty or inheritance tax. For a nominal fee, an assurance from the Minister of Finance may be obtained confirming that, in the event any legislation is enacted imposing any of the aforementioned taxes in Bermuda, such taxes will not be applicable to a private equity vehicle, its operations or to its shares or interests, debentures or other obligations (except insofar as such tax applies to persons ordinarily resident in Bermuda or is payable in respect of real property owned or leased in Bermuda). Currently, such an assurance may be obtained for a period until 31 March 2035. Exempted undertakings are exempt from Bermuda stamp duty.

Bermuda has entered into Model 2 intergovernmental agreements with the United States and the United Kingdom, requiring Bermuda financial institutions to report to the US IRS or UK HMRC on accounts held by US or UK citizens, respectively. Bermuda has implemented the OECD's Common Reporting Standard, permitting the automatic exchange of information among numerous countries to assist tax authorities in developing a clearer understanding of their residents' financial assets and income outside of their jurisdiction. Bermuda has further implemented the OECD Country-by-Country reporting, which permits tax administrations to perform high-level transfer pricing risk assessments and to evaluate other BEPS-related risks.

**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)?**

Please see the response to question 9.1 above. Structuring to achieve tax efficiencies is driven by onshore considerations

**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?**

Please see the response to question 9.1 above. Structuring to achieve tax efficiencies is driven by onshore considerations.

**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?**

Please see the response to question 9.1 above.

## 10 Legal and Regulatory Matters

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

More recently, key stakeholders, including the Government of Bermuda, the BMA, industry and professionals have collaborated to make legislative changes aimed at improving Bermuda's private equity product that serves to further bolster its position as a premier offshore jurisdiction for private equity fund transactions. Among the recent legislative changes is the introduction of the Incorporated Segregated Accounts Companies Act 2019, which adds to the range of vehicles available for private equity structuring. An incorporated segregated account is an attractive vehicle as it blends the benefits of a company with those of a segregated accounts company. They are cost-efficient as they avoid the expense of incorporating several separate companies and can be used for multi-strategy platforms.

As an enhancement to Bermuda's new Economic Substance regime, in January 2020, the IFA was amended to bring within its scope closed-ended investment funds (being Bermuda funds in which the participants are not, at their election, entitled to have their units redeemed) and overseas investment funds (being funds established outside of Bermuda but are managed or carry on promotion in or from within Bermuda). A number of private equity vehicles may fall within the new IFA definition of "investment fund", namely, any arrangement with respect to property of any description, including money, the purpose or effect of which is to enable a person taking part in the arrangement to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income. Such arrangements must meet the following characteristics: (i) the participants do not have day-to-day control over the management of the property (whether or not they have the right to be consulted or give directions); and (ii) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled and/or the property is managed as a whole by or on behalf of the operator of the fund.

The amendments to the IFA require overseas investments funds to, among other things, be designated by the BMA, and closed-ended investment funds to be registered with the BMA (unless an exclusion applies). Of the available categories in which a closed-ended investment fund may register, many private equity vehicles will likely register as "Professional Closed Funds". The notable requirements of Professional Closed Funds include that: its securities are only to be made available to "qualified participants"; it must appoint an auditor and a Bermuda-resident, licensed service provider (e.g., a fund administrator or corporate service provider) or officer, trustee or resident representative having access to the books and records of the fund; it must provide an investment warning in a form satisfactory to the BMA to participants prior to the sale of units; and it must prepare audited financial statements in accordance with International Financial Reporting Standards (IFRS) or recognised generally accepted accounting principles (GAAP). The definition of "qualified participants" has changed, such that the value of the individual's residence and benefits or rights under contracts of insurance are excluded from the calculation. Professional Closed Funds must annually certify that they meet the BMA registration requirements and provide the BMA with information on net asset value (NAV) and underlying assets, the latest audited financial statements and a statement of any material changes to the fund's terms of offering.

In keeping with Bermuda's aim to align with the global trend towards transparency, the Companies Act 1981 was amended to require a register of directors be publicly available and filed with the ROC. Such register is available on the Government of Bermuda website and contains the company name and registration number and the names and addresses of its directors (or company name and registered address for corporate directors). Similarly, the memorandum of association (and all amendments thereto), which sets out the powers and objects of the company, is publicly available. Additionally, Bermuda companies and partnerships must use reasonable efforts to identify their "beneficial owners" (and the beneficial owners of relevant entities) and maintain an up-to-date register thereof at their registered office. A beneficial owner is a natural person who directly or indirectly owns or controls more than 25% of the shares, voting rights or interest in a company or who controls a company by other means or, failing the existence of such persons, the company's senior managers. Certain of the beneficial owner information must be filed with the BMA (namely, name, address, date of birth, and nature and extent of interest in the company or partnership); however, such information is not publicly available.

The Government of Bermuda has long been committed to ensuring Bermuda anti-money laundering (AML) and anti-terrorist financing (ATF) requirements are aligned with the international standards, and has implemented recent legislative changes to further strengthen this regulatory regime. The scope of entities that fall within the definition of an AML/ATF Regulated Financial Institution, and therefore fall under the AML/ATF regulation and supervision umbrella of the BMA, has been expanded to include corporate service providers and fund administrators.

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

Investors and transactions are not, solely by reason of being private equity investors or private equity transactions, subject to enhanced regulatory scrutiny. Such investors and transactions, however, may attract enhanced regulatory scrutiny where the target is an insurance company, a bank, a telecommunications or utility company, investment business or other regulated entity and if the private equity vehicle is an investment fund. In such circumstances, the enhanced regulatory scrutiny would typically require transactional approval of the BMA, including the vetting of proposed shareholder controllers, officers and operators and service providers as fit and proper persons. See the response to question 4.1 above regarding closed-ended funds. The BMA also requires officers, operators and service providers to carry on business in a prudent manner and, in making such determination, the BMA may take into account any failure to comply with the IFA and other laws, codes of conduct and international sanctions.

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

Private equity investors will engage in detailed legal due diligence, including material business contracts, key employee contracts, confirming corporate compliance and searching charges and litigation filings. The timeframe, materiality and scope will differ depending on the target and the investors' risk tolerance, with smaller transactions typically involving less due diligence and larger transactions requiring more investor scrutiny with higher materiality thresholds. Legal due diligence can be expected to take several weeks, with the time depending, in large part, on the size of the transaction and the nature of the target.

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

Bermuda enacted new anti-bribery and anti-corruption legislation in 2016, which is modelled on the UK Bribery Act 2010. The Bribery Act 2016 criminalises private-sector bribery and makes it an offence to bribe a public official and a corporate criminal offence of failing to prevent bribery by an associated person. The scope of the Bribery Act 2016 is such that companies and partnerships incorporated or created outside of Bermuda are caught if they carry on business (or part of a business) in Bermuda. The only defence to the new corporate criminal offence of failing to prevent bribery is that the entity had "adequate procedures" to prevent persons associated with it from undertaking acts of bribery.

Given the seriousness of the offences and the potential for economic and reputations repercussions, private equity investors are apt to require seller warranties as to compliance with Bermuda's Bribery Act 2016 and all other applicable anti-bribery and anti-corruption laws.

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

The doctrines of the separate legal personality of Bermuda companies, and the limitation of liability of the shareholders of companies limited by shares to the unpaid amounts in respect of their shares, are foundational principles of Bermuda company law that are invariably upheld by Bermuda courts. It is inconceivable that they would not be upheld by Bermuda courts except in very rare instances where it can be shown that the company was improperly interposed by a controller to evade, conceal or frustrate enforcement of a liability. Investors should take note that if the directors are accustomed to acting in accordance with their directions or instructions of certain investors, such investors would fall within the definition of "officers" for the purposes of the Companies Act 1981 provision regarding offences by officers of companies in liquidation.

A limited partner is only liable for the unpaid amounts agreed to be contributed to the partnership. A limited partner must be mindful not to engage in management activities as it would risk losing its limited liability and could become liable for the debts and obligations of the partnership. However, subject to the LPA, a limited partner's membership on a board or committee of the LP will not in and of itself result in such limited partner owing a fiduciary duty to the partnership or other partners therein.

This limitation on liability typically remains in place even if LLC members actively participate in the management of an LLC. In fact, the ability of the members to both manage the day-to-day operations of an LLC while retaining their limited liability are two cornerstones of this structure and are particularly attractive to business owners.

If the directors are accustomed to acting in accordance with their directions or instructions of certain investors, such investors would fall within the definition of "officers" for the purposes of the Companies Act 1981 provision regarding offences by officers of companies in liquidation.

## 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?

Bermuda remains an attractive jurisdiction for investors as a well-regulated, politically stable and business-orientated jurisdiction. With market and regulatory uncertainties continuing to unfold globally – and in the United Kingdom, Europe and Hong Kong in particular – Bermuda remains well positioned to promote and to take advantage of its comparative state of certainty, stability, flexibility, creativity and responsiveness. The recent implementation of the Economic Substance regime in Bermuda means that Bermuda is enjoying a strategic advantage that this and its recent "white-listed" status give it over certain of its competitors.

Bermuda also has entities that offer corporate concierge services to international business, assisting new start-ups to find premises, helping staff with relocation arrangements, and providing introductions to local law firms and corporate service providers and offering serviced offices.

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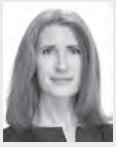

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Kennedys advises participants in private equity transactions, including funds, managers, target entities, banks and other financial institutions, on all aspects of the structuring and funding of acquisitions and investments. We also advise on equity and debt finance, restructuring and refinancing, joint ventures and governance and compliance matters. We have particular expertise in relation to transactions involving Bermuda insurance companies and insurance intermediaries, most notably commercial insurers and limited purpose insurers used in insurance-linked securities transactions.

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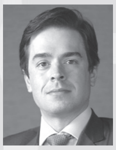
# Brazil



Carlos José Rolim de Mello


Roberto Panucci


Guilherme Simoes Tchorbadjian

Mello Torres




## 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 leverage 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?**

The COVID-19 pandemic and global issues such as supply chain disruption and inflation are the main factors impacting private equity transactions in Brazil. Nonetheless, even in this scenario, 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; and (iii) Brazil improved the laws and regulatory framework, being more attractive to private equity and venture capital investments. The increase in interest rates may impact fundraising and push general partners to increase the hurdle rate to keep private equity investments competitive.

**1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

The COVID-19 pandemic has impacted all countries, and Brazil is no exception. Nonetheless, private equity investments in Brazil showed a great resilience, with record-breaking numbers in 2020, 2021 and 2022. The depreciation of the Brazilian currency and the regulatory improvements counterbalanced the negative effects of COVID-19 in the Brazilian private equity industry.

The Brazilian government created a financial aid programme during the pandemic, which reached 68 million Brazilians. Such economic intervention prevented a severe slowdown, but, on the other hand, increased the debt of the Brazilian government and depreciated the Brazilian currency.

The currency devaluation affected the return of private equity funds, which invested in Brazilian companies in the past, since the private equity investors operating in Brazil carry out most of their fundraising offshore, and the devaluation of the Brazilian currency reduces the value of portfolio companies and the potential gain for investors. On the other hand, the weaker real increases the potential return of private equity funds carrying out new investment considering that the Brazilian currency may appreciate towards the US Dollar in the near future.

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

The 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' (investments above BRL 1 million) 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 also may 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, in case 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 the investors take a minority position to protect the investment, but 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 case someone decides 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. In order 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.

In case 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. In case 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, the steady and strong increase of the interest rates, combined with high inflation and foreign issues such as the Ukraine war, led investors to avoid riskier investments. This resulted in a decrease of the Brazilian IPO market, the exception being the privatisation of Eletrobras, a national giant in the energy sector.

### 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.

**7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?**

Although special purpose acquisition company (SPAC) entities are legal in Brazil and the Brazilian Stock Exchange already prepared a guide regarding such entities, they are not yet common.

## 8 Financing

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

The most common source of debt finance is taken with large financial institutions through loans and bonds (debentures). For this reason, 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 Tax Matters

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

The main 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, in case certain requirements are met, non-resident investors may benefit from special exemption on capital gains.

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

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.

**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?**

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.

**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?**

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.

## 10 Legal and Regulatory Matters

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

In 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; and (iv) the general review and restructure of rules issued by regulatory bodies. The FIP regulation issued by the CVM was also amended in 2016.

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

There is no enhanced scrutiny directed to private equity investors, but if a transaction is made in certain regulated sectors, prior approval by the regulatory bodies might be applicable.

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

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.

**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.)?**

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.

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

There are 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.

## 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?**

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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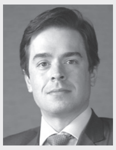

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Mello Torres advises Brazilian and foreign clients on the buy- and sell-side. The foreign clients include companies investing in Brazil for the first time and that require guidance to understand the complex Brazilian legal system, as well as those expanding their activities in the country.

Mello Torres supports their clients in all areas and stages of company and asset acquisitions, assisting and coordinating all aspects of the legal due diligence and competitive processes. This includes preparing letters of intent and offers, drafting and negotiating purchase and sale agreements and other related documents, as well as support during closing and other perfection procedures.

Furthermore, Mello Torres provides legal support with respect to all accessory aspects of M&A and private equity transactions, such as tax planning and analysis of complex transaction structures, in order to identify opportunities to increase efficiency and preserve clients' business value.

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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?**

Following a brief "pause" in early 2020 due to the COVID-19 pandemic, North American private equity reached record levels in 2021. While somewhat less than the peak, this strong level of activity has continued into the early parts of 2022; however, market volatility and signs of a pending economic downturn have many speculating that a slowdown will be forthcoming. According to the year-end market overview report by the Canadian Venture Capital and Private Equity Association, $18 billion of private equity was invested in 799 deals in 2021. Middle-market deals continued to be a significant driver in terms of total value invested, as 84% of the deals with disclosed value were under $25 million. The industrial and manufacturing sector and the information communications technology sector continue to capture the largest share of activity measured by both the number of deals and total value.

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

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

Continuing economic uncertainty from the COVID-19 pandemic, inflation and the war in Ukraine are the most significant factors currently inhibiting deals. However, 2021 demonstrated a positive recovery 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 attractive multiples on the sell-side.

From the private equity buyer's perspective, seller's valuation expectations remain high. Valuation multiples in Canada have remained high compared to long-term averages. According to Crosbie & Co., companies with an enterprise value of $100–$250 million traded at an average of 9×, a premium of 48% to small companies with an enterprise value of $10–$25 million, which traded at an average of 6×. However, valuations remain increasingly difficult to conduct as operations and supply chain disruption are a key focus of risk assessment and investors have to understand the financial risks associated with a target's trading partners, suppliers and customers caused by the pandemic.

The 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 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

The COVID-19 pandemic has introduced a number of trends that may impact deal activity in terms of the attractiveness of targets, including labour shortages and talent retention, increased regulatory oversight and the increasing risk of inflation. However, despite the COVID-19 pandemic, the market trends indicate a standard start for Canadian private equity investment in 2022.

There has been significant government support of the Canadian economy during the COVID-19 pandemic, including wage subsidies, rent subsidies, loans (a portion of which may be forgivable) and moratoriums on evicting defaulting tenants. These measures have influenced private equity activity by allowing certain companies to remain operating when they would have otherwise needed to shut down, allowing them to be acquired as a going concern by private equity interests. The short-term impact of these government initiatives on private equity investment has to be factored into the impact on EBITDA calculations for valuation purposes. EBITDA will, in many cases, be artificially inflated due to significant costs having been subsidised by the government stimulus programmes. Buyers need to be aware and adjust where appropriate. Sellers are not always willing to accept such adjustments, particularly in a competitive sale process. In the mid- to longer term, Canada was viewed as a relatively high tax jurisdiction pre-COVID-19 pandemic. Eventually, the cost of the many billions of dollars of government support provided will need to be repaid, with the expectation being that, over time, taxes will need to rise, resulting in Canadian businesses being less attractive as candidates for private equity investment.

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

Family offices and institutional investors, such as pension funds, are 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 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 will be more willing to acquire businesses that include real estate assets and will be more willing to consider acquiring manufacturing operations that have "legacy issues".

## 2 Structuring Matters

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

Privately held Canadian businesses are generally acquired by private equity buyers either through a purchase of assets or a purchase of shares. Private equity investors will typically incorporate a Canadian acquisition corporation and fund it by way of interest-bearing debt and equity on a 1.5:1 basis in order to comply with Canadian thin-capitalisation rules. This acquisition entity then acquires all of the shares/assets of the Canadian target and, in the case of a share acquisition, the acquisition corporation and target are then "amalgamated" under the relevant corporate statute to align the leverage with the operating company. Often, these buyout structures include key management rolling their interest and maintaining their equity stake. The then amalgamated operating company will then typically make add-on transactions by way of direct acquisition whereby the operating company will acquire the share or assets of an add-on target directly. Add-on acquisitions represent almost 70% of private equity buyouts in Canada, which is an accurate representation of the trend over the last four 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.

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

Whether a Canadian acquisition should be completed by purchasing assets or shares is driven by tax and non-tax considerations. The weight given to these factors will depend on the circumstances of the transaction and the parties' ability to leverage their respective positions. From the point of view of a potential purchaser, the greatest benefits of an asset sale are tax advantages and the ability to pick and choose the assets and liabilities that will be acquired. The majority of "legacy liabilities" can be left with the seller. However, asset sales tend to be significantly more complex in larger transactions and can require more third-party consents for material contracts. 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 $913,630 (as of 2022) lifetime personal capital gains exemptions to shelter a portion of the proceeds. Recent changes to Canadian tax rules 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 corporate purchaser. The precise terms of the equity interests offered to, or required of, continuing management are often a major point of negotiation in transactions. Typical structures include multiple classes of equity with one class designed to pay out investors, such as the fund and any co-investors (including management), in priority over a second class designed to pay out continuing management only if the business is eventually sold for more than a certain threshold value (incentive equity). Stock options (more tax-effective) or phantom stock options (less tax-effective) are also commonly granted.

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

Minority positions require private equity firms to consider different structuring issues due to the lack of control. The minority rights stipulated in the shareholders' agreement become 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 conditions. Those conditions are typically tied to either continued employment and the passage of time, and/or certain performance/success requirements, such as the achievement of stated financial returns. Generally, management equity is structured to allow for repurchase by the company upon a termination of employment. Options granted to management may vary on whether they are exercisable following termination of employment based on whether the termination was a "good exit" or a "bad exit" or on where the management ultimately lands following the exit. The options granted to management typically vest automatically in the event of a sale of the company by the private equity investor.

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

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

## 3 Governance Matters

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

Private equity firms utilise their equity positions, or negotiated minority rights, to assign seats on the board of directors to their principals and nominees. As such, they typically have the authority to run the portfolio company for the period of their investment. In Canada, the names and addresses of private companies' 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 announced that it intends to improve beneficial ownership transparency by creating a national public and searchable beneficial ownership registry for federally incorporated businesses before the end of 2023. The Canada Business Corporations Act currently requires federally incorporated businesses to maintain a record of beneficial owners in their corporate records. Newly introduced legislation currently under consideration by the Senate would require private federal business corporations to report beneficial ownership information to Corporations Canada annually and within 15 days of any change to the information contained in their corporate records pertaining to beneficial ownership. In Quebec, Bill-78, which has not yet come into force, will also make beneficial ownership information with respect to owners of Quebec corporations publicly available. However, Ontario, British Columbia, Manitoba, Saskatchewan, Nova Scotia, and Prince Edward Island have also introduced similar amendments to their corporate legislation, requiring companies to privately report or maintain records of their beneficial ownership structures. While this information for corporations formed under certain jurisdictions will not be public (under currently enacted legislation), it is indicative of 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 equivalent to 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 unanimous shareholders' agreement and, most notably, the fiduciary duty owed by the director of a portfolio company to the company itself cannot be restrained.

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

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

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

A shareholder agreement that is not signed by all of the shareholders of a company is treated as a regular commercial contract and, as such, not automatically enforceable against a subsequent shareholder; it is subject to the articles and by-laws of the corporation and the provisions of the relevant corporate statute. In contrast, a USA is a creature of statute, provided that it is signed by all shareholders. Corporate legislation expressly recognises the ability of shareholders to contract out of certain statutory requirements and fetter certain powers of directors. To the extent a USA restricts the powers of directors to manage the business and affairs of the corporation, shareholders who are given that power inherit the rights, powers, duties and liabilities of a director under corporate statutes or otherwise. Canadian courts will generally not enforce restrictive covenants that unnecessarily restrict an individual's freedom to earn a livelihood. What is reasonably necessary depends on the nature of the business, its geographic reach, and the individual's former role in that business. Canadian courts will not enforce a restrictive covenant that does not contain any time limit.

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

Depending on the jurisdiction of incorporation, the board of directors of a Canadian corporation may be subject to certain minimum residency requirements. Notably, boards of directors for companies incorporated under the federal statute must consist of at least 25% resident Canadian directors or include at least one resident of Canada if the board has fewer than four members. Residency requirements only remain under the federal statute, and the corporate statutes of Manitoba, Newfoundland and Labrador, and Saskatchewan. Most recently, Ontario and Alberta removed their director Canadian residency requirements, thus making those jurisdictions more attractive to foreign-owned private equity firms who want to have the boards of their Canadian portfolio investments aligned in terms of membership with those of their investments held outside of Canada.

In Canada, all directors owe fiduciary duties to the corporation, including a duty to act in the best interest of the corporation. The potential statutory liabilities directors are exposed to can be extensive and the basis for this potential liability varies. Directors may be personally liable for their own wrongdoing or failure, such as breaching the duties of loyalty and of care, or, in other instances, held personally liable for wrongdoing by the corporation. The statutes that impose liability on directors include those governing: corporate matters; securities compliance; employment and labour protection; taxation; pensions; bankruptcy and insolvency; and environmental. In Quebec, the recently adopted Bill-96 also introduces 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, recent amendments to Alberta's corporate statute have introduced 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 amendment 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 will be especially impactful on traditional private equity funds that are structured as limited partnerships. In addition to competition regulations, under the Investment Canada Act, foreign investments that exceed prescribed values or that relate to a cultural business or involve national security issues are subject to Investment Canada Act approval. This allows the federal government to screen proposed investments to determine whether they will be of "net benefit" to Canada. Recent amendments to the Investment Canada Act now permit non-Canadian investors 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. 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 during 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 typically do not have an anti-sandbagging provision). 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. Over recent years, the number of typical carve-outs and exclusions from such policies has decreased quite significantly. However, they remain for pre-closing taxes, pension funding, the potential recharacterisation of consultants as employees, certain environmental 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 demand exceeded the ability of the insurers to keep up with demand and premiums increased, generally policy premiums for representations and warranties insurance have declined in recent years and now may range between 2.5–4% of the policy limit. The retention amounts required under these policies have similarly declined. It is now common to see this figure ranging between 0.5% to 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 that common in Canada and are the exception rather than the typical exit scenario. According to the Canadian Venture Capital and Private Equity Association, in the first quarter of 2022, while the exit market saw a record high of 42 exits in a given quarter, 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 state of the market before the pandemic and the increased use of these processes in the United States, we expect to see them becoming more common in Canada as buyers continue to seek ways to hedge the risk of a failed attempt to go public while at the same time increasing valuations.

**7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?**

Canada's special purpose acquisition company ("SPAC") market remains quiet in comparison to the U.S., where SPACs raised over $130 billion in capital in 613 IPOs over the course of 2021, in comparison to Canada's 94 SPAC IPOs raising under $1 billion in capital. Potential market challenges when considering a "de-SPAC" transaction include the possibility of increased dilution based on deal structure, the possibility that the SPAC may want to pay the purchase price partly in equity and warrant issuances and the cumbersome and costly process of closing a "qualifying acquisition". If the SPAC fails to complete a "qualifying acquisition", the fees related to the SPAC's operational expenses and transactional costs will be lost.

## 8 Financing

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

Foreign investors, largely U.S.-based, account for a substantial portion of private equity investment in Canada. U.S. investors often bring their American debt financing with them or obtain Canadian debt financing. Private equity investors utilising U.S. debt sources for Canadian private equity transactions need to develop FX hedging strategies, which are typically only provided by traditional banks and can be costly. Traditional senior secured debt obtained from a domestic Canadian bank, often in the form of a revolving credit facility or term loan, remains the most common source of debt financing in Canadian private equity transactions. At times, senior secured debt is also supplemented by mezzanine financing (usually by way of subordinated debt) through banks or other financial institutions.

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

There are no relevant legal requirements or restrictions that affect the choice of structure used for debt financing in

Canadian private equity transactions. Canadian loans tend to be fully secured against all available collateral.

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

Most private equity firms typically use private lending as part of the financing for their Canadian transactions. According to Crosbie & Co., the average equity portion of the capital structure returned to its long-term average of 47% in 2021, after rising to 49% of all transaction value in 2020.

## 9 Tax Matters

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

Many of the common tax considerations in transactions with private equity funds apply equally to transactions with strategic buyers. However, there are several considerations that may take on added importance when transacting with foreign private equity investors in particular. Dividend payments made by Canadian portfolio companies to foreign private equity investors are generally subject to a 25% withholding tax, although this rate is substantially reduced under tax treaties in most instances. Non-resident investors should also familiarise themselves with Canada's thin-cap rules that prohibit Canadian companies from deducting interest on a portion of interest-bearing loans from specified non-residents that exceed one-and-a-half times the tax equity of the "specified non-residents" in the Canadian company. Historically, intermediary entities in tax-favourable jurisdictions such as Luxembourg and the Netherlands 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.

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

Stock options remain the most popular 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.

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

Investors in a Canadian company are generally permitted a tax-free rollover when exchanging their shares in the company for shares of another Canadian company, but not when such shares are exchanged for shares of a non-Canadian company. An effective workaround may be available in the latter circumstances through the use of "exchangeable shares" (i.e., shares of a Canadian company that are exchangeable for, and are economically equivalent in all material respects with, shares in the relevant foreign company).

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

As noted above, the Organisation for Economic Cooperation and Development's BEPS initiative, insofar as anti-treaty-shopping measures are concerned, has significantly decreased foreign-based private equity funds' usage of intermediary entities in favourable jurisdictions (such as Luxembourg and the Netherlands) for their Canadian investments. Amendments to the Excise Tax Act (Canada), enacted in 2018, impose goods and services tax obligations on investment limited partnerships. These changes imposed goods and services tax on management and administrative services provided by the general partner of an investment limited partnership. If the partnership meets the definition of "investment limited partnership", the general partner will be obligated to charge and remit goods and services tax on the fair market value of any management/administrative services provided. As of July 1, 2021, amendments were enacted to the Income Tax Act to introduce a $200,000 annual limit on the eligibility of employees of certain businesses to claim a 50% tax deduction for stock option grants. This could affect the compensation packages required to retain and incentivise management.

## 10 Legal and Regulatory Matters

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

Recent amendments to the Competition Act (Canada), most of which came into force on June 23, 2022 as part of the Budget Implementation Act, 2022, allow orders that companies ordered to produce information must provide information in the possession of their affiliates, and orders that require persons outside of Canada to provide information. Given the 2021 amendments to the Competition Act to include non-corporate entities as affiliates, funds structured as partnerships are now considered affiliates of both portfolio companies under their control and any other similarly structured sister funds controlled by the same entity. This increases the number of entities that may be subject to the orders made to companies to produce information in the possession of their affiliates.

Separately, the Canadian government introduced regulations amending the national security review regime under the Investment Canada Act, the amended regulations 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. The amended regulations will come into force on August 2, 2022.

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

Private equity investors are not subject to specific regulatory scrutiny; however, the amendments to the Competition Act noted above are likely to increase the number of private equity transactions that trigger advance notice requirements under the Competition Act. Foreign investments that constitute an acquisition of "control" of a Canadian business will require approval under the Investment Canada Act if the investment exceeds certain monetary thresholds, involves a cultural business, or has national security implications. Such investments are subject to approval by the federal Ministry of Innovation, Science and Economic Development or the Minister of Canadian Heritage, depending on the nature of the Canadian business being acquired. 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.

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

The majority of private equity investors conduct 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 by external counsel and other professionals, such as environmental consultants. While legal due diligence has been conducted virtually for a significant amount of time, given the shift to virtual business and management level due diligence stimulated by the COVID-19 pandemic, due diligence review strategies have become more modernised and efficient. The length of the diligence review and materiality threshold applied differs greatly and is often dependent on the nature of the sale process, the risk tolerance of the private equity investor and the industry the target is in.

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

Canada's Corruption of Foreign Public Officials Act ("CFPOA") was enacted in 1998 to ensure commercial fair dealing, government integrity and accountability, and the efficient and equitable distribution of limited economic resources. CFPOA prohibits the promise, payment, or giving of money or anything of value to any foreign official for the purpose of obtaining or retaining business or gaining an improper advantage and concealing bribery in an entity's books and records. Private equity transactions, especially in sensitive industries or which involve a target with material government contracts, typically specify diligence contracts as well as corporate records and policies for compliance with this legislation. In addition, representations and warranties are often obtained from the seller confirming the entity's compliance with the same. While the Foreign Corrupt Practices Act ("FCPA") is an American law, U.S. private equity investors often seek assurances that Canadian target entities are complying with FCPA. If the Canadian target is not currently owned by an American interest, this can be problematic.

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

Typically, Canadian courts are hesitant to pierce the corporate veil and hold shareholders liable for their portfolio companies. However, Canadian courts will pierce the corporate veil where a corporate entity is controlled and used for fraudulent or improper conduct. Likewise, to the extent a shareholder usurps the discretion of a director to manage the business, that shareholder will expose itself to the liabilities of a director of the entity, including where a USA or unanimous shareholders declaration is used to remove the powers of the directors and instil such powers in a shareholder.

## 11 Other Useful Facts

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

Other factors that commonly raise concerns for private equity investors, especially foreign investors, include: that foreign ownership in specified industries such as financial services, 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 may introduce 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. In the province of Quebec specifically, the recently adopted Bill-96 may raise further considerations in terms of investment in entities with operations in Quebec, giving more onerous obligations for entities operating in Quebec to comply with French language requirements. Lastly, 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).

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# Cayman Islands


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## 1 Overview

### 1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?

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 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

The legal, regulatory and tax environment in the Cayman Islands remains favourable for structuring of both the raising of private equity funds and for downstream cross-border deal activity in the longer term. This is affirmed by continued robust fund formation and transactional activity in 2022. The private equity industry continues to look to capitalise on current market opportunities, including those presented by the COVID-19 pandemic.

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

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

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

## 2 Structuring Matters

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

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

The Cayman Islands fund vehicle will generally invest via other Cayman Islands vehicles, including aggregator vehicles, or entities domiciled outside the Cayman Islands, such as in Delaware, Luxembourg or Ireland, depending on where the ultimate operating portfolio company or target entity is located. Ultimately, net returns from the underlying company or target will be distributed to the Cayman Islands domiciled fund vehicle, which net returns will 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 a limited partnership.

For an exempted company, the board of directors is responsible for the overall management and control of the company. The composition of the board of directors of a portfolio company tends to vary depending on the nature of the private equity transaction. A director of an exempted company is in a fiduciary relationship to the company and owes various duties of a fiduciary nature, which may be broadly characterised as duties of loyalty, honesty and good faith. Every director owes these duties individually and they are owed to the company as a whole. Specifically, they are not owed to other companies with which the company is associated, to the directors or to individual shareholders. In addition to the fiduciary duties, each director owes a duty of care, diligence and skill to the company.

An LLC can be member-managed or can appoint a separate board of managers. There is significant flexibility as to governance arrangements with respect to an LLC, which can be agreed by the parties in the LLC agreement. The default duty of care for a manager or managing member is to act in good faith. This standard of care may be expanded or restricted (but not eliminated) by the express provisions of the LLC agreement.

An exempted limited partnership is managed by its general partner. The general partner has a duty to act in good faith and, subject to the express provisions of the limited partnership agreement, in the interests of the partnership.

Operator information, being director, manager or general partner details (as applicable), can be obtained from the Cayman Islands registry. Commercial arrangements are not publicly available and generally information will only need to be disclosed with consent or in limited, appropriate circumstances, such as with law enforcement agencies or regulatory and tax authorities upon legitimate lawful and proper request.

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

This is generally a case-by-case consideration based on the commercial circumstances of each transaction.

Investors in a Cayman Islands private equity fund do not typically enjoy veto rights over major corporate actions. For funds structures structured as exempted limited partnerships, the general partner must act within any limitations agreed in the limited partnership agreement of the fund (for example, as to business purpose, limitations on investment, limitations on indebtedness and guarantees, etc.). A limited partner advisory committee will often be established to approve any conflict transactions of the general partner or fund manager. A minority investor would not typically enjoy any veto rights.

At an operating company level, it is very common for transaction parties to agree that certain matters will be reserved to shareholders acting by requisite thresholds, which may include veto rights or various minority protections, or require enhanced director approvals. These arrangements would be reflected in the company's governing documents, which would typically include a shareholders' agreement.

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

There is no limitation on reflecting veto arrangements in governing documents, although it requires a case-by-case analysis to determine how such arrangements should be accommodated most effectively in a specific context.

If structured as an exempted company, certain veto arrangements may be better afforded to shareholders as opposed to director nominees in light of the fiduciary duties owed by directors. There is greater flexibility where an LLC is employed. Such vehicles, by way of example, are particularly well suited to joint ventures given the governing documents may authorise a manager to act in the interests of his 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 exempted company and the public acquisition were structured by way of a merger, then such investors may be able to avail themselves of dissenting shareholder rights and apply to the Courts seeking fair value for their shares.

## 6 Transaction Terms: Private Acquisitions

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

The operating companies and deal terms for specific portfolio investments are generally not governed by Cayman Islands law and are non-Cayman Islands considerations typically driven by onshore tax and regulatory considerations.

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

The operating companies and deal terms for specific portfolio investments are generally not governed by Cayman Islands law and are non-Cayman Islands considerations typically driven by onshore tax and regulatory considerations.

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

The operating companies and deal terms for specific portfolio investments are generally not governed by Cayman Islands law and are non-Cayman Islands considerations typically driven by onshore tax and regulatory considerations.

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

The operating companies and deal terms for specific portfolio investments are generally not governed by Cayman Islands law and are non-Cayman Islands considerations typically driven by onshore tax and regulatory considerations.

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

The operating companies and deal terms for specific portfolio investments are generally not governed by Cayman Islands law and are non-Cayman Islands considerations typically driven by onshore tax and regulatory considerations.

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

The operating companies and deal terms for specific portfolio investments are generally not governed by Cayman Islands law and are non-Cayman Islands considerations typically driven by onshore tax and regulatory considerations.

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

The deal terms for specific portfolio investments are generally not governed by Cayman Islands law, nor driven by Cayman Islands considerations. As such, the comfort provided and sellers' enforcement rights with respect to financing commitments reflect commercially agreed terms and are typically negotiated and agreed by onshore deal counsel.

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

The operating companies and deal terms for specific portfolio investments are generally not governed by Cayman Islands law and are non-Cayman Islands considerations typically driven by onshore tax and regulatory considerations.

## 7 Transaction Terms: IPOs

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

This will depend primarily on which exchange the 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.

**7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?**

The increase in special purpose acquisition company ("**SPAC**") activity over the past few years has certainly seen a number of private equity sellers look to a de-SPAC exit over a traditional IPO. The de-SPAC process offers certain advantages over a traditional IPO, including the speed of execution (as little as three to six months, as opposed to 12–18 months for a traditional IPO) and the access to additional capital through private investment in public equity ("**PIPE**") funding. However, recent SEC focus on the de-SPAC process, including proposals to align more closely with traditional IPO requirements with respect to liability for persons deemed to be underwriters of the de-SPAC transaction, combined with the decrease in PIPE activity and increase in SPAC shareholder redemptions in connection with de-SPAC transactions, has resulted in a slowing in the number of de-SPACs in the market.

## 8 Financing

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

The Cayman Islands is a leading "creditor-friendly" jurisdiction, where both Cayman Islands and non-Cayman Islands security packages are respected and recognised. Financing counterparties are very familiar with, and comfortable lending to, Cayman Islands vehicles, which are able to access the full range of debt finance options seen in the market. Common private equity financing structures include subscription line facilities secured on investors' capital commitments, and leveraged finance facilities secured by the relevant target group's assets.

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

There are no specific Cayman Islands statutory restrictions impacting the type of debt financing activity that can be undertaken and Cayman Islands vehicles are generally able to access the full range of debt finance options seen in the market. Restrictions on debt financing may, however, be contained in the constitutional documents of the Cayman Islands vehicle (such as a limited partnership agreement in the case of a partnership), the terms of which would be agreed by the sponsor and investors on launch of the fund.

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

There has been a continuation of the use of all subscription and bridge facilities across the private equity market with a marked increase in financings involving the use of wholly owned investment companies incorporated in the Cayman Islands. The vehicles are structured as bankruptcy-remote with at least one independent director or manager, as the case may be, appointed to the board. This satisfies the lender's bankruptcy concerns and provides strong credit protection for the secured parties. These financings include plain vanilla loans, note issuances and also various derivative transactions including total return swaps and repurchase structures.

## 9 Tax Matters

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

The Government of the Cayman Islands does not, under existing legislation, impose any income, corporate or capital gains tax, estate duty, inheritance tax, gift tax or withholding tax upon: (i) Cayman Islands-exempt companies, exempted trusts, LLCs or exempted limited partnerships established to operate as private equity funds or portfolio vehicles; or (ii) the holders of shares, units, LLC interests or limited partnership interests (as the case may be) in such private equity vehicles. Interest, dividends and gains payable to such private equity vehicles and all distributions by the private equity vehicles to the holders of shares, units, LLC interests or limited partnership interests (as the case may be) will be received free of any Cayman Islands income or withholding taxes.

An exempted company, an exempted trust, LLC or an exempted limited partnership may apply for, and expect to receive, an undertaking from the Financial Secretary of the Cayman Islands to the effect that, for a period of 20 years (in the case of an exempted company) or a period of 50 years (in the case of an LLC, an exempted trust or an exempted limited partnership) from the date of the undertaking, no law that is enacted in the Cayman Islands imposing any tax to be levied on profits or income or gains or appreciations shall apply to the vehicle or to any member, shareholder, unitholder or limited partner (as the case may be) thereof in respect of the operations or assets of the vehicle or the interest of a member, shareholder, unitholder or limited partner (as the case may be) therein; and may further provide that any such taxes or any tax in the nature of estate duty or inheritance tax shall not be payable in respect of the obligations of the vehicle or the interests of a member, shareholder, unitholder or limited partner (as the case may be) therein.

The Cayman Islands is not party to a double tax treaty with any country that is applicable to any payments made to or by private equity vehicles.

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

As the Cayman Islands is a tax-neutral jurisdiction, these arrangements are typically driven by the tax laws of the jurisdictions where the management team is located. However, Cayman Islands law allows for significant scope and flexibility to structure management equity programmes in a wide variety of ways.

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

As the Cayman Islands is a tax-neutral jurisdiction, these arrangements are typically driven by the tax laws of the jurisdictions where the management team is located.

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

The Cayman Islands has signed an inter-governmental agreement to improve international tax compliance and the exchange of information with the United States (the "**US IGA**"). The Cayman Islands has also signed, along with over 100 other countries, a multilateral competent authority agreement to implement the OECD Standard for Automatic Exchange of Financial Account Information – Common Reporting Standard ("**CRS**" and, together with the US IGA, "**AEOI**").

Cayman Islands regulations have been issued to give effect to the US IGA and CRS (collectively, the "**AEOI Regulations**"). All Cayman Islands "Financial Institutions" (as defined in the relevant AEOI Regulations) are required to comply with the registration, due diligence and reporting requirements of the AEOI Regulations, unless they are able to rely on an exemption.

## 10 Legal and Regulatory Matters

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

The Cayman Islands continues to refine its laws and regulatory framework to ensure that it meets the ever-increasing demands of the private equity industry. This ability to respond and adapt has resulted in the following legal developments over recent years:

- On 30 November 2020, the ability to register a Cayman Islands LLP under the Limited Liability Partnership Act (As Revised) was enforced. The registration process for an LLP is similar to that for other forms of Cayman Islands vehicles. An LLP combines the flexible features of a general partnership, but has the benefit of separate legal personality and affords limited liability status to all its partners. In the context of private equity, an LLP's features and flexibility provide additional structuring options for general partner or management vehicles or fund of funds or holding partnerships. The PF Act (as defined below) makes provision for registration of an LLP as a private fund. Given the relative infancy of the LLP, this chapter does not address the LLP in any material detail.
- On 7 February 2020, the Private Funds Act (As Revised) (the "**PF Act**") came into force pursuant to which certain closed-ended funds (termed "private funds") are required to register with the Cayman Islands Monetary Authority. The adoption and implementation of the PF Act reflects the Cayman Islands' commitment as a co-operative jurisdiction, is responsive to EU and other international recommendations and covers similar ground to existing or proposed legislation in a number of other jurisdictions.
- On 27 December 2018, the Cayman Islands published the International Tax Co-operation (Economic Substance) Act (As Revised) as a response to global OECD Base Erosion and Profit Shifting ("**BEPS**") standards regarding geographically mobile activities. The Cayman Islands Economic Substance regime robustly addresses the ethos of the legislation without materially impacting the private equity industry. Requirements of this type are rapidly being implemented on a level playing field basis by all OECD-compliant "no or only nominal tax" jurisdictions.
- The Cayman Islands was an early introducer of comprehensive and strict anti-money laundering laws and "know your client" rules and regulations, and continues to adapt these rules and regulations in line with international standards. In a continuing effort to meet international standards, a comprehensive update was made to the Cayman Islands Anti-money Laundering Regulations in October 2017 and further revisions continue to be made as international standards evolve, including by applying sanctions, including administrative penalties, that are intended to be effective, proportionate and dissuasive.
- The enactment of the Limited Liability Companies Act in 2016 provided for the formation of a new Cayman Islands vehicle: the LLC. Since its introduction, we have seen

LLCs used in private equity structures, particularly as GP governance vehicles, aggregator vehicles (where multiple related funds are investing in the same portfolio investment) and holding companies/blockers in portfolio acquisition structures.

- A comprehensive review and update to the Exempted Limited Partnership Act took place in recent years, and additional enhancements are proposed. While neither the current law nor the proposed revisions make fundamental alterations to the nature, formation or operation of exempted limited partnerships, the statute promotes freedom of contract and includes provisions to deal specifically with issues and concerns raised and suggestions made by the industry to bring the Exempted Limited Partnership Act even further in line with Delaware concepts and developing industry practices, including electronic closing platforms.

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

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

A private equity transaction to acquire a business located in or regulated in the Cayman Islands such as a local bank, insurance company or utility services provider may be subject to scrutiny by CIMA and the Cayman Islands Trade and Business Licensing Board.

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

The approach to legal due diligence depends on the particular sponsor and may also vary on a transaction-by-transaction basis.

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

The Cayman Islands' Anti-Corruption Act (As Revised) (the "**AC Act**") came into force on 1 January 2010 with the intent of giving effect to the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, as well as the United Nations Convention Against Corruption. The AC Act replaced the provisions relating to anti-corruption and bribery that previously existed under the Penal Code, and provides generally for four categories of corruption offences: Bribery (both domestic and foreign); Fraud on the Government; Abuses of Public or Elected Office; and Secret Commissions. There are also ancillary offences for failure to report an offence. The impact of the AC Act on private equity transactions in the Cayman Islands, given the sophistication of the parties involved and the nature and quality of their transactions, has been minimal, although more commonly transaction documents now include a warranty relating to compliance with such laws.

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

As a general rule, in the absence of a contractual arrangement to the contrary, the liability of a shareholder of a Cayman Islands-exempt company that has been incorporated with limited liability and with a share capital is limited to the amount from time to time unpaid in respect of the shares he or she holds. A Cayman Islands company has a legal personality separate from that of its shareholders and is separately liable for its own debts due to third parties. Accordingly, a company's liability does not generally pass through to its shareholders.

The general principles regarding corporate personality under Cayman Islands law are similar to those established under English law, and a Cayman Islands Court will regard English judicial authorities as persuasive (but not technically binding). Accordingly, from the date of incorporation of a Cayman Islands company, it is a body corporate with separate legal personality capable of exercising all the functions of a natural person of full capacity. This includes the ability to own assets, and perform obligations, in its own name as a separate legal person distinct from its shareholders (*Salomon v. Salomon & Co.* [1897] A.C. 22).

As a matter of English common law, it is only in exceptional circumstances that the principle of the separate legal personality of a company can be ignored such that the Court will "pierce the corporate veil". These circumstances are true exceptions to the rule in *Salomon v. Salomon*, and there is now a well-established principle under English law that the Court may be justified in piercing the corporate veil if a company's separate legal personality is being abused for the purpose of some relevant wrongdoing.

## 11 Other Useful Facts

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

Cayman Islands private equity vehicles play a well-established and growing role in private equity fund structures. This role is evidenced by the growing number of exempted limited partnership registrations in the Cayman Islands. Statistics issued by the Registrar of Partnerships have confirmed that in the years since the 2008 financial crisis, the Cayman Islands has seen a consistent increase in the number of annual partnership registrations. In 2021, the number of active exempted limited partnerships stood at 35,075, compared with 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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# China



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## 1 Overview

**1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?**

The most common types of private equity transactions in the People's Republic of China (PRC) are mergers and acquisitions (M&A) and growth investments. 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?**

During the first half of 2022, the private equity market has been relatively quiet due to COVID-19 restrictions, geopolitical tension, PRC regulatory uncertainty over the regulation of offshore initial public offerings (IPOs), U.S. regulatory uncertainty over the regulation of U.S. investments in the PRC, and PRC and U.S. regulatory uncertainty over the continued viability of U.S. listings for PRC companies.

**1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

No, the general trend has been a steady increase in private equity activity in the PRC market, with a shifting focus towards M&A as growth companies mature. The PRC's regulatory regime on offshore IPOs, combined with U.S. regulatory uncertainty, however, has created a new dynamic that will be different from the immediate past. Differences include the primary IPO exit being in Hong Kong, the adjustment or transaction structures with more weight given to PRC structures, and increased awareness of new regulatory items such as cybersecurity, antitrust, and export controls compliance.

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

The 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. 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. We notice that both of these types of private equity investors are beginning to reach equilibrium with each other in terms of practice. In the immediate past, big PRC Internet companies were also active in the private equity space, but that activity is now subject to heightened regulatory scrutiny, in particular, antitrust.

## 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 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 prevalent (and we suspect will become more so) as target companies adjust their group structures for regulatory reasons.

**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", as defined by the PRC's updated Anti-Monopoly Law that will take effect on 1 August 2022, necessitating a merger review filing if new updated thresholds are also met. There has been substantial enforcement by PRC authorities over prior growth investments where a merger review filing was not submitted by the transaction parties under the old Anti-Monopoly Law; the maximum fine was RMB500,000, whereas it can be up to 10% of global turnover under the new law.

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

The typical range for equity allocated to management, and the terms of such equity, varies significantly in the PRC and depends on the nature of the fund (e.g. international, Asia-focused, PRC-focused), the general partner (PRC or non-PRC), and the extent to which local teams have autonomy. Transaction-specific management equity is common in the PRC market, and can be found even at international private equity funds. We have also started to see Management Equity Plans (MEPs) adopted post-completion in relation to management equity for a particular target.

### 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). In some cases with local funds, good leaver and bad leaver distinctions were not set forth in management equity plans with specificity, which has led to disputes.

## 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 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.

### 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 over the budget and business plan and/or the appointment or dismissal of officers 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. "Control" in other contexts may also be deemed to exist where the investor exerts substantial influence over the target. While merger review applications may be filed in simplified and expedited form, transaction parties typically attempt to avoid adding rights that may trigger a merger review filing.

### 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 a 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 minimal consideration varies by province but in general it is at least 30% of the most recent compensation provided to the departing employee.

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 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. 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 online private education. The variable interest entity (VIE) structure has been a mature structure in existence for over 20 years, which allows 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. Major PRC Internet companies have used the structure to attract private equity investment and then list in Hong Kong or the U.S. However, recent regulatory developments in the PRC and in the U.S. on offshore IPOs of PRC companies (including those using an offshore structure) may change the continued viability of VIE structure, especially in the context of an offshore IPO.

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. PRC antitrust authorities have in the past two years conducted a series of retroactive reviews under the old Anti-Monopoly Law of transactions that were not filed even though they met regulatory thresholds. Under the new Anti-Monopoly Law, expedited review where a decision is made in as little as one to two months is possible. Furthermore, antitrust authorities now accept applications where one or more of the transaction parties has a VIE structure, whereas previously those applications were not accepted even if the transaction parties wanted to file.

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

The offshore IPO rules by the PRC and the delisting law by the U.S. have the potential to fundamentally alter the *status quo* from the last 20 years. As such, transaction terms over the last two to three years have accounted for these risks, in particular as they relate to redemption provisions tied to regulatory enforcement of the VIE structure and the inability of the portfolio company to complete a qualified IPO within a set time period.

## 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, which may be forced to list pursuant to the U.S. delisting law, 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, 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 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. PRC-specific warranties relate to foreign exchange and cybersecurity. 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 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 in various jurisdictions that 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. A target with a VIE structure will have higher W&I insurance costs.

### 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.

### 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 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 11.1) 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 PRC has recently enacted rules regulating offshore IPOs that previously did not apply to PRC companies with offshore structures (including VIE structures). For Hong Kong listings, the listing applicant will have to produce to the China Securities Regulatory Commission (CSRC) a compliance certificate from its primary regulator. This requirement does not actually deviate from the "material non-compliance" requirement of the Stock Exchange of Hong Kong. For any other listing outside of Hong Kong (e.g. U.S./Singapore) listings, in addition to the compliance certificate, listing applicants who hold personal information of 1 million or more PRC persons will also require prior approval from the Cybersecurity Administration of China (CAC). Neither the compliance certificate nor the CAC approval were previously required for U.S. or Singaporean listings. In addition, the U.S. has implemented its delisting law, the Holding Foreign Companies Accountable Act, and has stated in a speech released on the website of the Securities and Exchange Commission on 24 May 2022 that U.S. listed PRC companies will be delisted starting in March 2023 if the PRC authorities do not soon accede to U.S. demands on audit inspections in the PRC. As of the date of this guide, no such agreement has been reached by U.S. and PRC authorities. Target companies whose parent entities are incorporated in the PRC may list in Hong Kong through the "H shares" arrangement, but in practice cannot list anywhere else outside of Mainland China.

**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 are less common in the PRC market. When exploring an exit, sellers usually select an exit option over the other. The typical time period for a Hong Kong IPO from start to finish is around six months.

**7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?**

De-SPAC transactions are still in a nascent stage in the PRC, even though the Stock Exchange of Hong Kong has allowed special purpose acquisition companies (SPACs). Regulatory headwinds in the U.S. over the delisting law has caused many potential de-SPAC transactions involving PRC companies to be delayed or not completed.

## 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 form of debt financing for private equity transactions is borrowing from traditional banks, either on a singular or inter-creditor 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 are both subject to registration requirements from the State Administration of Foreign Exchange and the National Development and Reform Commission. 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 Tax Matters

**9.1 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.

**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)?**

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. One vehicle used by management is a trust that allows the management to pay a lower tax on the exercise and roll over of the option shares to the trust, in anticipation of a future exit through an IPO or M&A.

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

The key tax considerations typically involve the amount of cash consideration they 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 who incurred capital gains tax as a result of a merger.

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

The 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.

## 10 Legal and Regulatory Matters

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

The recent offshore IPO rules, the uncertainty over the future of the VIE structure, and U.S. regulatory developments such as the continued implementation of the delisting law and potential "outbound CFIUS" regulation, individually and taken as a whole may very well change the PRC investment landscape from the prior *status quo* of the last 20 years. The rules on the PRC side provide greater clarity on what is and is not permitted, and their continued implementation may result in greater legal certainty for all investors. Hong Kong may be strengthened as a capital markets gateway for PRC companies in the future.

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

Private equity investors are not treated any differently compared with other non-PRC investors. Investments in restricted or prohibited sectors, 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. Growth investments in restricted industries up to the 50% ownership threshold should continue in the future. However, investments in prohibited sectors in light of recently regulatory developments are uncertain.

### 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.)?

Very few, if any, PRC target companies are fully compliant with all PRC legal obligations. As such, legal due diligence in PRC M&A tends to be more detailed and time consuming compared with other jurisdictions. Recent regulatory development on cybersecurity and offshore listings rules have further enhanced the importance of legal due diligence. 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.

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

The PRC's anti-bribery and anti-corruption regime has been enforced with more regularity recently and should be viewed alongside other diligence items such as tax and permits. The basic approach to anti-bribery and anti-corruption legal due diligence and contractual protections, however, has remained relatively unchanged.

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

Shareholder liability 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.

## 11 Other Useful Facts

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

One area of 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 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.

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## 1 Overview

**1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?**

Throughout the past few years, the private equity market has continued to grow in France and this trend has not been impacted by the COVID-19 pandemic nor the current global economic and political volatile situation. The private equity market has been quite active in all segments and has shown excellent performance. There has been marked interest in companies specialising in "resilient" sectors, such as health, science and technology and more importance given to cleantech companies. Mostly, this year has seen private equity in France boom significantly and the sector represents the highest progression in Europe and seven new French companies have become unicorns. Although 2021 is considered record breaking in the private equity market, experts predict a slower evolution, mainly due to the current volatile economic and political situations.

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

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

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

**1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

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

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

Companies, heavily indebted, are now seeking to strengthen their equity but also need to adapt their sectors and step forward to their digital transformation.

Challenges for investors are twofold: rightly choose their target companies and position themselves to finance such companies, but also obtain an interesting ROI based on the current increase of valuation multiples. As per our answer to question 1.1, experts predict that there will probably be challenges in the coming months due to the rise in interest rates and the current volatile economic and political situations.

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

We have noticed throughout the past few years that end investors have been requesting a more thorough review of the Corporate Social Responsibility ("CSR") commitments from their portfolio and have integrated these elements into their standards. End investors not only seek investments and financing projects with an important financial return on investment ("ROI") but also seek to have a positive social, environmental or societal impact. This trend is expected to grow because of the success story of impact funds, which specifically seek to implement investments that generate a measurable, beneficial social and/or environmental impact, in addition to a financial return (for instance, job creation in specific geographical areas, waste minimisation, etc.).

## 2 Structuring Matters

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

Firstly, and from a purely corporate legal structuring point of view, it is important to note the difference between the private equity vehicle and the actual structure that will control the various investments carried out by the private equity fund.

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

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

In some other cases, there can also be other holding companies between the actual controlling investment structure and the fund.

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

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

However, and as mentioned above, considerations based on CSR are also gaining in importance, and this trend will become more pronounced insofar as regulations impose transparency obligations on management companies with regard to their investment policy. The Taxonomy Regulation (Regulation (EU) 2020/852 of June 18, 2020) to which institutional investors are already subject, will facilitate the common classification at EU level for the information on which these will be analysed.

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

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

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

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

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

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

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

The equity allocated to the management usually ranges from 10% to 15%. The analysis to structure each such package should be made with good care and in relation to the compensation and tax issues, taking into account the July 2021 Conseil d'Etat decisions on management packages. Free shares can be interesting but, among other restrictions, cannot represent more than 10% of the outstanding share capital of the issuing company. These shares are allocated to the managers and can either be ordinary or preferred shares. It is also interesting to note that BSPCEs are privileged in venture capital since they are not subject to this specific limitation. Sweet equity packages can also be implemented, which consist of having the managers invest only in the capital while the private equity investor will primarily invest in convertible bonds. This scheme offers the management a higher portion of the share capital. Specific care should be taken when drafting the value of the ratchet shares and more specifically with regard to tax impacts and the requalification of such package as part of the management salary.

Subject to the above-mentioned reclassification issues, these packages may also contain leaver clauses and specific call options, as well as specific drag-along rights to the majority private equity investor.

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

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

## 3 Governance Matters

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

Most of the time, private equity portfolio companies adopt the form of a SAS in France, which offers a high degree of operational flexibility and whose governance arrangement is freely determined by the articles of association. Generally, a board (often referred to as a "*comité stratégique*") is set up and the investor(s) have one or more mandatory members of the board. The parties freely determine the power of the board. When these are provided for in the articles of association, the operating conditions of the board are consequently published at the commercial registry and, as mentioned above, accessible to the public. In the case where this board has similar powers as within a board of directors or a supervisory board in an SA, the identity of its members is published on the incorporation document (Kbis). It is also possible to provide for the existence of such a board in the shareholders' agreement rather than in the articles of association. In such case and as mentioned above, it remains confidential. Usually, the existence of the board is provided for in the articles of association, but the actual governance rules, the distribution of seats, reinforced majorities or even veto rights, are specified in a shareholders' agreement, which remains confidential.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

## 4 Transaction Terms: General

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

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

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

Currently, there is a record of number of deals in private equity following the first COVID-19 lockdown. Most private equity investors were eager to finalise the transactions before the presidential elections in France (May/June 2022). This is a direct consequence of the tax and labour law reforms, which have been implemented during the past four years. The market is flourishing and France will probably live up to its ambition of becoming a major player on the European market.

## 5 Transaction Terms: Public Acquisitions

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

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

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

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

## 6 Transaction Terms: Private Acquisitions

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

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

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

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

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

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

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

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

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

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

- adjustments of the scope or prior operations including divestments, acquisitions, mergers, change of legal form, etc. – such covenants shall cover the treatment of any consequence triggered by the adjustment (tax, labour, financial, etc.);
- the management of the target company during the interim period and restrictive covenants on certain decisions, costs and expenses;
- warranties and indemnities, including *de minimis*, thresholds, cap, and "guarantee of the warranties" mechanisms/any specific warranty mechanism;
- non-competition and non-solicitation undertakings; and
- closing deliveries.

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

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

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

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

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

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

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

Private equity sellers will resist any sort of security for any warranties/liabilities.

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

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

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

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

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

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

Even though such clauses prove to be very interesting, we have not (or very scarcely) encountered them in private equity deals. We would say that they are not common practice in the French Market.

## 7 Transaction Terms: IPOs

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

The market risk is probably an important challenge, together with the time and cost of an initial public offering ("IPO") exit. Private equity investors should also be careful when lock-up agreements are included within the shareholders' agreement.

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

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

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

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

**7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?**

The special purpose acquisition company ("SPAC") market has been very slow in France since the end of 2020 and the start of 2021. The first de-SPAC transaction in France since 2016 took place in April 2022.

## 8 Financing

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

The main source of financing is the subscription of a loan from a credit institution or a banking pool. Companies can also obtain financing through bonds (straight or convertible bonds into shares) or bank loans, or resort to both bond financing and a bank loan; such so-called "mezzanine" financing, have significantly increased since 2020 (through the rise of unitranche financing for example).

The increase in the interest rates will have an impact on the debt financing as it will impact private equity as a whole (with actors such as Blackstone already recording a significant slowdown).

However, banks and senior loans should still remain an efficient and key part of any structured 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?**

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

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

One of the most notable trends has been the rise of unitranche financing since 2020, with some well-established banks setting up their own unitranching offers.

Another noteworthy trend is the development of decentralised structured finance teams within banks away from Paris, as teams in various regions (Nantes, Marseille, Lyon, etc.) are built by banks with the capacity to engage in small to mid-cap operations and also to lead syndication in such operations without intervention from their central (often located in Paris) offices, thus making the local markets more dynamic.

## 9 Tax Matters

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

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

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

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

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

As such, the use of off-shore structures is not common.

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

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

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

Within the tax-consolidation regime, the "*Charasse Amendment*" provides for a partial recapture of financial expenses borne by a French tax group when: (1) a tax-consolidated company acquires shares of another company from an entity that is not part of the French tax group but that controls the acquiring company or is under common control with the acquiring company; and (2) the acquired company joins the tax group.

However, if the sellers become minority shareholders following the transaction, it does not influence the decision to opt for the tax consolidation regime. On the contrary, if the sellers remain majority shareholders, the "*Charasse Amendment*" may lead to the exclusion of the acquired entity from tax consolidation.

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

Further to the presidential and legislative elections in June 2022, the French government and parliament focused, in the July 2022 Finance Bill, on maintaining the purchasing power despite the inflation.

## 10 Legal and Regulatory Matters

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

The general legal and regulatory framework described throughout this chapter illustrates the French market's ambition to become a central player in private equity. These are namely with regard to tax and labour but also some recent reforms on individual entrepreneurs, as well as the Loi Rixain, to name a few.

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

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

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

Generally speaking, any serious due-diligence process conducted by private equity investors is carried out with a lot of care, thus rendering the process fairly long depending on the size, complexity, maturity and area of activity of the target. The due diligence may be pushed further depending on the nature of the private equity's funders. However the French market in the recent years has also shown that red flag audits have become predominant and, in some very rare cases, investors may also be satisfied by sanity checks.

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

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

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

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

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

## 11 Other Useful Facts

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

Under French President Emmanuel Macron, a series of rules have been simplified in order to favour foreign investments in France. Among these recent modifications, are the simplification of French labour law and the progressive reduction of corporate income tax. Brexit-related issues should still be anticipated and should mainly be in favour of French attractiveness for foreign investments. Finally, as mentioned above, general

CSR, as well as sustainable development concerns, will continue to strive in the French private equity market, namely and as mentioned at the beginning of this chapter, with the success of impact funds.

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FIDAL

# Germany

Kirkland & Ellis

Dr. Thomas Diekmann

## 1 Overview

### 1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?

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

In 2021, private equity investors carried out more transactions in Germany than ever before. Sectors that experienced the strongest activity include the information technology, healthcare, industrial and consumer sectors. The largest private equity transactions in 2021 were the acquisitions of ceramics manufacturer CeramTec and the shoe manufacturer Birkenstock for EUR 3.8 billion each.

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

As in other markets, the German market for private equity transactions recognised a high incentive for investors in 2021 to deploy the massive amounts of available dry powder, also resulting in an increased number of public-to-private deals. While this trend was expected to continue through 2022, as of the end of Q2 2022, the geopolitical uncertainties associated with the Russia-Ukraine conflict, inflation and rising interest rates slowed down activity also in German M&A markets and do not allow a reliable prediction for the second half of 2022.

### 1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

The German government provided a number of different COVID-19 relief measures, including government-funded short-time work, tax deferrals, state-backed guarantees and loans. In addition, specific measures were introduced to German restructuring and insolvency law, including the suspension to file for insolvency under certain circumstances. At the time of writing, most of these measures have expired.

While 2021 was an exceptional year of deal activity and 2022 was expected to also become a strong year for private equity in Germany, due to the uncertain macroeconomic environment (see question 1.2), it is at this point difficult to foresee which long-term effects specifically the COVID-19 pandemic will have for the private equity market in Germany.

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

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

## 2 Structuring Matters

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

## 3 Governance Matters

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

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

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

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

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

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

In a situation where the investor holds a minority position, the investor will seek to obtain veto rights in order to protect its economic interest in the target group against related party transactions between the target group and the controlling shareholder that are not at arm's length as well as fundamental changes to the business of the target group.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

See question 3.6. The duty of loyalty requires that managing directors act in the best interest of the company. As the interest of the private equity investor would usually align with the interest of the company and the target group, there is, in practice, little room for conflicts of interests between the managing directors and the private equity investors.

## 4 Transaction Terms: General

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

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

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

Transactions by non-German investors in highly sensitive industries (such as arms, military equipment and IT security products) or by non-EU/EFTA investors in specific sectors classified as "critical" (such as critical infrastructure, cloud computing, medical devices, artificial intelligence, cyber security, robotics, autonomous driving and flying, quantum and semiconductor technology) may require clearance by the German Ministry of Economics. A standard clearance process will take between four to eight weeks and may be conducted between signing and closing.

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

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

## 5 Transaction Terms: Public Acquisitions

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

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

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

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

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

## 6 Transaction Terms: Private Acquisitions

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

In times of a strong sellers' market, the vast majority of private transactions provide for locked-box structures. Compared to completion account structures, locked-box structures may be advantageous for private equity investors (both on the sell-side and the buy-side), as they provide for purchase price certainty, allowing investors to calculate the needed funds for the purchase price paid (buy-side) and permit the immediate distribution of funds (sell-side), as no post-closing adjustment will be required.

Completion account structures remain relevant for larger carve-out transactions or in case a newly formed group of formerly independent companies is being sold and consolidated accounts are not yet available.

Deferred purchase prices, particularly through earn-outs or vendor loans, are common. Re-investments (roll-overs) by the seller into the private equity investor's purchaser structure are common in primary transactions (i.e. purchase from a non-private equity seller) and have also increased in secondary transactions (i.e. purchase from a private equity seller).

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

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

In addition, the seller may provide tax indemnities (often subject to W&I insurance) and certain other indemnities with regard to special items identified by the buyer during diligence.

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

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

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

Selling managers often grant non-compete covenants and other restrictive covenants.

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

W&I insurance has become standard in private equity transactions to bridge the gap between sellers' and buyers' interests in a clean closing (see also question 6.2). Policy terms largely depend on the insurer, target industry, quality of diligence, and availability of the management, the term and deductible, and the liability cap. Typically, excess amounts are between 0.25% and 0.5% and policy limits between 10% and 20% of the enterprise value; excess under the W&I policy can be set irrespective of the management/warrantor liability under the SPA which is typically set at EUR 1. The cost of the insurance is approximately 1% to 1.3% of the amount insured.

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

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

Warranties usually survive a limited time after closing and are capped and further limited by *de minimis* and thresholds or baskets.

Fundamental warranties usually have longer survival periods than other warranties and are capped at the purchase price; even longer periods commonly apply to tax indemnities.

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

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

Given the limited amount of warranties being provided by private equity sellers and the wide availability of W&I insurance, escrows have become unusual for private equity sellers.

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

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

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

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

## 7 Transaction Terms: IPOs

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

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

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

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

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

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

**7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?**

While the special purpose acquisition company ("SPAC") IPO market in Germany is slowing down, the high number of funds raised by already listed SPAC entities and the requirement of these entities to implement their initial business combination within the SPAC entities' lifespan would usually suggest an increase in the number of de-SPAC transactions also in the German transaction market. However, the uncertain macroeconomic environment (see question 1.2) and the high competition between SPAC entities approaching their deadline in the transaction market may impede the ability of SPAC entities to find an acquisition target in time and, ultimately, may require some of them to liquidate and return the funds raised in the IPO to their investors.

In a German to U.S. de-SPAC Business Combination, a Dutch holding structure is usually the preferred option as Dutch corporate law provides for less technical requirements and more flexibility.

## 8 Financing

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

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

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

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

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

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

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

Although debt was widely available during 2021 and debt providers sought to provide financing to all sorts of transactions, the uncertain macroeconomic environment (see question 1.2) led to increased interest rates for acquisition debt financing and a more careful consideration of financing commitments by debt-financing providers.

## 9 Tax Matters

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

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

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

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

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

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

The management will want to ensure to participate in a future exit via management incentive programmes (MIPs). Therefore, the management is regularly provided with actual or virtual shares, which may generate high returns under certain criteria (such as the fulfilment of certain key performance figures). Under German tax law, virtual share option programmes (VSOP) are more flexible in this regard and can be narrowly tailored to the parties' preferences in the individual case. However, VSOP income principally qualifies as employment income, which will be taxed at the individual tax rate of the German manager of up to 47.5% (plus church tax (*Kirchensteuer*), if applicable). In contrast, if certain guidelines are followed, proceeds from actual equity share programmes may qualify as capital gains, which would be subject to German flat tax (*Abgeltungsteuer*) at a beneficial rate of 26.4% (plus church tax (*Kirchensteuer*), if applicable) or the partial tax regime (*Teileinkünfteverfahren*) at a beneficial rate of approx. 28.5% (plus church tax (*Kirchensteuer*), if applicable).

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

The management's main focus will be to ensure that tax will only be due upon receiving proceeds from a sale in order to avoid dry income (tax). Depending on the relevant structure and when following certain clearly defined steps, equity rollovers can be structured in a tax-neutral way in order to avoid triggering realisation events.

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

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

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

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

In addition, the German legislator has now implemented the rules to combat hybrid mismatches resulting from hybrid entities or hybrid financial instruments in cross-border structures under the so-called ATAD I/II Directive into domestic law. Given that common private equity structures involve various jurisdictions and different entities, these rules and their potential impact are taken into consideration when structuring acquisitions.

## 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?**

Over recent years, the German Foreign Direct Investment Act and the Foreign Trade and Payments Ordinance were subject to multiple revisions, providing for a broader scope of transactions subject to German foreign direct investment control and lower requirements for a potential intervention by the German authority. The most recent is the revision of the Foreign Trade and Payments Ordinance effective on 1 May 2021, which significantly expanded the catalogue of sectors designated as "critical" subject to mandatory review (see also question 10.2).

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

Transactions by non-German investors in highly sensitive industries (such as arms, military equipment and IT security products) or by non-EU/EFTA investors in specific sectors classified as "critical" (such as critical infrastructure, cloud computing, medical devices, artificial intelligence, cyber security, robotics, autonomous driving and flying, quantum and semiconductor technology) may require clearance by the German Ministry of Economics.

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

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

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

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

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

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

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

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

## 11 Other Useful Facts

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

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

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KIRKLAND & ELLIS

# Hong Kong


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## 1 Overview

**1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?**

Hong Kong is one of the largest private equity hubs in Asia, with around 600 private equity firms and over US$170 billion of assets under management. Private equity focuses predominantly on transactions outbound from Hong Kong into businesses in Mainland China, across multiple sectors. Transactions in Hong Kong itself often focus on technology, FinTech, logistics and real estate.

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

The overall state of the private equity market has been adversely affected by economic headwinds consequent to strict COVID-19 controls both in Hong Kong and Mainland China, as well as uncertainty in government policy.

Beyond political and economic factors, in Hong Kong, the government has introduced a number of initiatives to strengthen Hong Kong as a base for private equity transactions. These initiatives have included the introduction of a new limited partnership fund regime to enable private equity funds to register (or re-domicile) in Hong Kong and the introduction of tax measures to limit profits tax on the exit of portfolio transactions and on carried interest earned from such transactions.

**1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

Travel restrictions and quarantine requirements have posed a major challenge to private equity and, as at the time of writing this article, continue to weigh on activity. The Hong Kong government responded to the pandemic with an economic package that, although not intended to stimulate the economy to the extent seen in some other jurisdictions or provide the liquidity to spur M&A activity, included subsidies to support employment and to guarantee loans.

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

There has been growing participation in private equity transactions by family offices. By way of background, in 2020 there has been an approximate 46% year-on-year increase in the assets under management in Hong Kong's private banking and private wealth management business attributed to family offices and private trust clients. With the recent legislative proposal to provide tax concession for eligible family-owned investment holding vehicles managed by single family offices in Hong Kong, in order to further attract ultra-high-net-worth individuals to set up and operate family offices in Hong Kong, it is expected that family offices may become an emerging investor base for private equity funds alongside traditional institutional investors.

## 2 Structuring Matters

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

Private equity transactions in Hong Kong typically use an offshore company to hold a Hong Kong company, which, in turn, holds the underlying business in which the investment is being made.

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

Transactions in shares of Hong Kong companies are subject to stamp duty and the use of an offshore company can enable an exit of an investment without stamp duty.

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

Institutional private equity investors may take ordinary shares, preferred shares, convertible notes or a combination of the foregoing. When possible, convertible notes provide the upside of equity as well as some downside protection as a creditor. Preferred shares may provide for redemption rights as well as the right to convert into ordinary shares.

Management may take ordinary shares, typically to align their interests with those of the institutional investors, sometimes as sweet equity and sometimes as part of a rollover. Management may receive additional shares subject to ratchet mechanisms to incentivise performance. Management shares may be voting or, in some cases, non-voting.

Carry is typically addressed at the fund level rather than at the portfolio level.

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

In a minority position, the private equity investor will wish to put in place a shareholders' agreement. The investor may seek to include in this agreement various rights to ensure the business is governed in a manner satisfactory to the investor. These rights may include the right to board representation and veto rights over certain company activities. The latter may include restrictions on transactions otherwise than on an arm's-length basis and transactions that would incur liabilities beyond a prescribed threshold. Other rights, such as tag-along rights, pre-emptive rights, and rights of first refusal, may be included to protect the investor's ability to exit with other shareholders, to protect the investor from being diluted and to protect the investor from being forced into a relationship with an unknown or unfriendly shareholder.

A controlling shareholder may seek to include in the shareholders' agreement drag-along rights and a right of first offer to ensure that it is able to effect an exit through a sale of the whole business and to protect itself from being forced into a relationship with an unknown or unfriendly shareholder.

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

Management equity will vary depending on the size and the specific terms of each transaction, as well as on any management shareholding existing at the time of a transaction. It would not be uncommon to see total management equity in the range of 10% to 20% of the ordinary share capital with vesting over a period of three to five years. A private equity investor will typically seek a right to compulsorily acquire management equity from an executive who ceases employment with the business.

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

Generally, a management equity holder will be treated as a good leaver if leaving for reasons of death, ill health, or retirement. On the other hand, a management equity holder may be treated as a bad leaver if leaving voluntarily ahead of meeting agreed milestones, if terminated for cause or in any circumstance otherwise than 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?

See the response to question 2.4. Generally, governance arrangements are not publicly available as they are set out in the shareholders' agreement and this agreement is a private document that will not need to be filed with any public registry. This is so where the investment is made into a Hong Kong company or in a company incorporated in any of the offshore jurisdictions that are typically chosen.

However, certain governance arrangements may need to be supported by provisions in the articles of association or other constitutional documents of the private equity portfolio company. This is because a shareholders' agreement is a contractual document that binds the shareholders who are parties to it but which may not bind the company. In this case, these provisions may be registered with a public registry and may be available through a public search.

For example, if a private equity investor and a founder agree in the shareholders' agreement that each will have the right to appoint a director to the board, it may be convenient to provide in the articles of association for two classes of ordinary shares, each class having its own right to appoint a director.

### 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?

Each transaction will vary as to veto rights. However, private equity investors will generally seek veto rights over changes to the company's share capital structure, acquisitions and disposals of key assets, related party transactions, the incursion of liabilities (or business plans and budgets) above certain pre-agreed thresholds, and other proposed changes that may have a material impact on the company's financial performance.

### 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?

Hong Kong company law generally operates on the basis that the management of a company rests with the board of directors, meaning that the shareholders have no right to manage the day-to-day affairs of a company unless specifically authorised to do so by the articles of association. It is unusual to reserve specific management decisions to the shareholders in the articles of association. As a result, veto rights at the shareholder level will normally be limited to matters within the statutory jurisdiction of the shareholders.

Conversely, Hong Kong company law generally reserves to the shareholders certain decisions and the board of directors has no right to make these decisions. As a result, veto rights at the board level will normally be limited to matters that fall within the day-to-day management of the company only and that are outside the range of decisions reserved by company law to the shareholders.

At the same time, Hong Kong company law provides that certain shareholder decisions must be taken either by ordinary resolution (meaning a resolution passed by a simple majority) or by special resolution (meaning a resolution passed by a majority of at least 75% of the shareholders present or voting on a poll) and any agreement purporting to bind the company to a different threshold of approval is unenforceable.

To address these limitations, veto rights are normally set out in a shareholders' agreement. The company is specifically excluded as a party to this agreement and the shareholders are obliged under the agreement to procure a state of affairs to give effect to the veto rights. As these steps only provide contractual protection and do not stop decisions in breach of contractual veto rights having effect as a matter of company law, careful consideration must be given to whether veto rights will be placed at the shareholder level or the board level and amendments to the articles of association may be adopted.

### 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 Hong Kong company law, shareholders generally owe no duties to other shareholders as regards how they vote or otherwise how they exercise rights attached to their shares.

### 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 Hong Kong law, shareholders' agreements are generally enforceable provided that they do not purport to bind the company to a position that is inconsistent with statutory company law requirements. This means that whilst private equity investor shareholders are generally free to make personal agreements (*e.g.* in relation to the exercise of their personal voting rights) to bind one another, a shareholders' agreement will be unenforceable to the extent that it, for example, fetters a company's right to undertake an act (*e.g.* to alter its articles or remove a director, provided that the requisite resolutions have been passed) that the company is entitled to undertake pursuant to companies law legislation.

Similarly, Hong Kong law generally recognises choice of law and jurisdiction clauses. Sometimes, in the context of a shareholders' agreement, a party may wish to align the law of the contract with the law of the company to ensure consistency. Investment documentation involving a Mainland Chinese counterparty may reflect enforcement needs, including the possibility of an exclusive Hong Kong jurisdiction clause for a Hong Kong court to render a judgment that can be enforced in Mainland China by treaty, or the use of arbitration for dispute resolution to take advantage of a number of treaties providing for enforcement in Mainland China of interim and final awards in arbitral proceedings seated in Hong Kong.

In principle, non-compete and non-solicit provisions are enforceable in Hong Kong provided that they protect legitimate business interests and the restraint in question is no more than is reasonably necessary to protect those interests. However, as enforcement of such provisions require the exercise by the court (or arbitral tribunal) of discretion as to reasonableness, the parties may prefer to seek protection through clauses restricting the disclosure and use of confidential information.

### 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 owe duties under Hong Kong law, including a statutory duty of care to exercise reasonable care, skill and diligence as well as a fiduciary duty to act *bona fide* in the best interest of the company. These duties may limit the ability of nominee directors to act solely in the interest of the shareholders appointing them. A breach of these duties may result in personal liability for a director.

As a general principle, the shareholders may ratify breaches of these duties by a director. A private equity investor cannot vote to ratify a breach by a director connected to it (*e.g.* an employee of the private equity sponsor) but the shareholders' agreement may require another shareholder to vote to ratify a breach consistent with this agreement.

Directors may owe other duties in specific circumstances. For example, if a portfolio company goes public, under Hong Kong law, directors consenting to or authorising the issue of the prospectus may be liable for any untrue statement. It is not possible to ratify a breach of such a duty.

As shareholders, as a matter of company law, private equity investors do not owe duties to the directors whom they nominate. Liability may attach under employment law to private equity investors as employers of employees whom the private equity sponsor may nominate as a director.

Hong Kong company law restricts a company from indemnifying a director for liability of a director to the company for breaches of duties owed by the director to the company. A company may take out directors & officers liability insurance to indemnify a director from expenses in defending proceedings alleging default by a 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?

Under Hong Kong company law, a director must declare to the board any direct or indirect material interest the director may have in a proposed arrangement being considered by the board that is significant to the company. The articles of association of companies often provide that a director must refrain from voting in respect of such an arrangement and must not be counted in the quorum of the board meeting to consider that arrangement.

## 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?

Hong Kong laws do not generally impact transaction timetables but specific circumstances may result in the application of laws that may do so. Most significantly, if a portfolio company is regulated, regulatory approvals may delay the timetable. For example, if the portfolio company is licensed by the Securities and Futures Commission ("**SFC**"), a transaction in which the private equity investor becomes a substantial shareholder cannot complete until the SFC approves the investor and any entities in the holding chain.

There are no anti-competition or anti-monopoly merger controls that apply generally in Hong Kong. Merger controls currently only regulate mergers involving telecommunications carriers.

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

There has been an enhanced emphasis on integrating environmental, social and corporate governance ("**ESG**") factors into investment selection, due diligence and portfolio value creation processes.

## 5 Transaction Terms: Public Acquisitions

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

A public-to-private transaction in Hong Kong structured as a share acquisition is subject to the SFC Code on Takeovers and Mergers ("**Takeovers Code**").

As companies listed on the Stock Exchange of Hong Kong ("**SEHK**") are often controlled by a family or a single controlling shareholder, a typical take-private deal may take the form of either (i) a sale and purchase agreement with the controlling shareholder followed by a general offer, or (ii) a voluntary offer with a pre-agreed irrevocable commitment from the controlling shareholder to accept this offer.

In the former, the general offer will be mandatory if the private equity investor acquires 30% or more of the voting rights of the company from the controlling shareholder.

The Takeovers Code requires that all shareholders in a general offer be treated fairly and equally, and hence, as a principle, the private equity investor must offer terms to the non-controlling shareholders at least as good as those offered to the controlling shareholders.

A mandatory general offer cannot be subject to any conditions other than a condition ("**acceptance condition**") that the buyer receive acceptances to the offer to secure more than 50% of the voting rights of the company. However, a voluntary offer may be subject to other conditions.

It should be noted that if a buyer needs to arrange financing for an offer, the financing must in any event be in place before it makes the offer.

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

Because most companies listed on the SEHK have a controlling shareholder, it is possible for a private equity investor to negotiate deal protections in arrangements with the controlling shareholder. For example, where a private equity investor acquires the shares of the controlling shareholder and then makes a mandatory general offer, the purchase and sale agreement between the investor and the controlling shareholder may include common deal protections such as representations and warranties and indemnities from the controlling shareholder.

However, the Takeovers Code imposes certain restrictions that may limit the availability of deal protections that otherwise might be available to a private equity buyer in a private acquisition. For example, the Takeovers Code limits the ability of a buyer to enter into special deals with selected shareholders if those arrangements have favourable conditions that are not extended to all shareholders. As a result, private equity investors may require regulatory consent before offering retention incentives to company management who have existing equity stakes in the company.

On the flip side, the Takeovers Code offers certain inherent safeguards for a buyer. Most significantly, in the absence of shareholder approval, the Takeovers Code prohibits a target company from taking any action to frustrate an offer once the offer has been communicated to the board.

## 6 Transaction Terms: Private Acquisitions

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

Cash consideration is generally preferred in private equity deals. Post-completion price adjustment mechanisms are commonly seen and adjustments are usually based on net assets, working capital or a combination of both. Locked-box mechanisms are sometimes used to provide greater certainty for private equity sellers in exit deals.

### 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 usually give limited representations and warranties (*e.g.* relating only to the seller's title to the shares, and capacity and authority for entering into the sale). Management teams are usually expected to give extensive warranties (*e.g.* relating to audited and management accounts, accuracy of disclosure materials) to a 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?

Some pre-completion covenants may require that the seller procure the target portfolio company not to engage in certain conduct that may otherwise diminish the value of the company post-signing. It is also increasingly common to see data privacy and sanctions-related warranties.

Management teams may be subject to non-compete and non-solicit provisions for a certain period post-completion (see question 3.5).

### 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?

Representations and warranties insurance is gaining popularity in Hong Kong. Policy limits typically range between 10–20% of the deal value. The policy will generally exclude cover for known matters, specific indemnities (*e.g.* indemnity for tax liability, litigation or environmental claims) and forward-looking statements. The premium typically ranges between 2–3% 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?

Liability for limited warranties (*e.g.* title) will often be capped at the purchase price. Liability for general warranties will typically be capped at up to 30–50% of the purchase price.

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

Escrow and retention amounts are less commonly used now as more parties are looking to manage risks by representations and warranties 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.)?

As private equity buyers often use a newly incorporated special purchase vehicle with little financial substance or creditworthiness to act as the buyer entity, to provide comfort to the seller that the buyer entity will be able to meet its obligations to pay the purchase price upon completion, private equity buyers funding the purchase may issue an equity commitment letter in favour of the buyer entity, but would generally resist granting the seller specific third-party rights to enforce such commitment letter. Where part of the purchase will be funded by debt financing to be provided by a third-party lender, debt commitment letters may be issued by the lender in favour of the buyer entity, though these may not be enforceable by the seller.

Sometimes, a seller may require a buyer to provide a guarantee in the seller's favour to guarantee the buyer entity's completion obligations. In circumstances where the buyer entity agrees to pay to the seller a reverse break fee in the event that it fails to complete the purchase due to lack of finance, the private equity buyer may provide a limited guarantee in favour of the seller up to the amount of the reverse break fee.

### 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 sometimes used (see question 6.7) but are not widely seen in Hong Kong.

## 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 initial public offering ("**IPO**") remains a popular exit channel for private equity investors. In Hong Kong, there are two options for an IPO; namely a listing on the Main Board ("**Main Board**") of the SEHK or a listing on the Growth Enterprise Market ("**GEM**") Board of the SEHK.

A listing on the Main Board requires (among others) satisfying one of the following tests:

- Profit Test – The listing applicant must have a trading record of not less than three financial years, during which the profit attributable to shareholders must, in respect of the most recent year, be not less than HK$35 million and, in respect of the two preceding years, be in aggregate not less than HK$45 million.
- Market Capitalisation/Revenue/Cash Flow Test – The listing applicant must have a market capitalisation of at least HK$2 billion at the time of listing, revenue of at least HK$500 million in the most recent audited financial year, and positive cash flow from operating activities of at least HK$100 million in aggregate for the three preceding financial years.
- Market Capitalisation/Revenue Test – The listing applicant must have a market capitalisation of at least HK$4 billion at the time of listing and revenue of at least HK$500 million in the most recent audited financial year.

A company seeking a listing on GEM must, among others, have a positive cash flow from operating activities of at least HK$30 million in aggregate for the two preceding financial years and a market capitalisation of at least HK$150 million at the time of listing.

Private equity investments made in close proximity in time to a listing on the SEHK may be subject to restrictions on the types of terms available to the private equity investor on the basis that the private equity investor should not receive terms more favourable than the investing public without assumption of real market risk.

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

In a Main Board listing, a controlling shareholder (*i.e.* a shareholder controlling the exercise of 30% or more of the voting power at general meetings, or the composition of a majority of the board of directors) of the listed company is not allowed to dispose of its shares for up to six months (*i.e.* first lock-up period) from the listing date. Thereafter, it is not allowed to dispose of its shares for a further six months (*i.e.* second lock-up period) if such disposal would result in it ceasing to be a controlling shareholder.

Similarly, in an exit by a GEM listing, a first lock-up period of 12 months followed by a second lock-up period of 12 months applies.

Private equity sellers who are controlling shareholders would be expected to give undertakings consistent with regulatory requirements. Private equity sellers who are cornerstone investors may be expected to give undertakings not to dispose of their shares for six to 12 months from the listing date, such undertakings to be subject to consent by the underwriters.

### 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?

Whilst the possibility of exiting by a sale or by an IPO will generally be considered, a decision on exit is usually made before a seller is heavily invested into either option; it has, therefore, historically been less popular in Hong Kong to pursue a dual-track exit process. Recent reversals in the Hong Kong market may affect this dynamic.

### 7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?

As the listing regime for special purpose acquisition companies ("**SPACs**") in Hong Kong only came into effect on January 1, 2022 and the first SPAC only listed on the Main Board in March 2022, as at the time of writing, there has not been a de-SPAC transaction so far. It remains to be seen whether private equity investors may seek potential de-SPAC mergers over an IPO exit.

Based on the current landscape, it is possible to expect more SPAC listings seeking to identify de-SPAC targets with businesses in the Greater China area in the "new economy" sectors such as green energy, advanced technology, healthcare, biotechnology and life sciences, the consumer lifestyle and retail sector, as well as the financial services and technology sector.

## 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).**

Historically, banks have been the most common providers of financing for private equity transactions but more alternative (non-bank) lenders are entering this space. Capital call lines and acquisition financing secured by the shares being acquired continue to dominate but more difficult borrowing conditions have seen an uptick in interest in non-traditional products, which may, for example, call for a broader package of security over a pool of securities of portfolio companies.

**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?**

Hong Kong law restricts companies incorporated in Hong Kong from providing financial assistance for the purchase of their own shares. These restrictions may, for example, limit the ability of a purchaser of a target portfolio company from using the assets of that company to secure the debts incurred by the purchaser in financing the purchase. However, particularly in the context of a control transaction, these restrictions may not apply if, for example, among other things, the directors of the target portfolio company confirm that the company is solvent and resolve that the giving of the financial assistance is proper.

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

Please see our discussion at question 8.1.

## 9 Tax Matters

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

Offshore structures are common for tax purposes but new tax legislation allows for more local Hong Kong structures.

As noted in question 2.2, transactions in shares of Hong Kong companies may be subject to stamp duty. The use of a company incorporated offshore (*i.e.* outside Hong Kong) to hold a portfolio company can bypass stamp duty on a sale of the portfolio company.

Where a person is regarded as carrying on a business in Hong Kong and has profits arising in or derived from Hong Kong from such business, profits of the person may be subject to Hong Kong profits tax.

The place of incorporation of a company neither determines where it carries on a business nor where its profits arise in or are derived from. However, where the management and activities of a company lie offshore outside Hong Kong, the company may be regarded as outside the reach of Hong Kong profits tax. Such a company, if used to hold a portfolio company, may not be subject to profits tax on any gain in the value of its investment in the portfolio company.

Under Hong Kong tax laws, a private equity fund and its holding vehicles may be exempt from Hong Kong profits tax if they meet qualifying conditions. These conditions include a requirement that either (i) the fund sponsor be licensed by the SFC or that transactions for the fund otherwise be arranged by a person licensed by or registered with the SFC, or (ii) the fund have a minimum number of arm's-length investors who have given capital commitments to a minimum level. Other conditions relate to holding periods or control over a portfolio company.

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

Hong Kong tax laws offer limited room for tax sheltering or deferral for share-based awards. Benefits associated with share-based awards arising from an individual's office or employment will be included in his or her assessable income for the purpose of assessing Hong Kong salaries tax. The individual will be assessed on the gains realised under a share award when the shares vest or, in the case of a share option scheme, when the option is exercised.

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

The sale of management team shares to the buyer or the transfer of such shares into a new holding vehicle for the business may trigger stamp duty and, potentially, profits tax.

However, it is possible that any profit arising from such sale or transfer may be exempt from profits tax on the basis that it is a capital gain or on the basis that management is not carrying on a business, profession or trade in such shares.

Stamp duty applies if the shares are shares of a Hong Kong company. However, it may be possible to minimise stamp duty if the Hong Kong company issues new shares to the acquisition vehicle on a thin capital basis.

**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?**

Over the past few years, the Hong Kong government has introduced a number of tax initiatives to strengthen Hong Kong as a private equity hub.

One initiative is the introduction of a new exemption, known as the unified funds exemption, which exempts qualifying profits earned by a private equity fund or its holding vehicles from Hong Kong profits tax arising from portfolio transactions.

A second initiative offers a tax concession for private equity fund managers carrying on their business from Hong Kong. Under this concession, such managers pay a 0% rate of profits tax on eligible carried interest.

A third initiative proposes to offer a profits tax exemption on profits earned by single family offices on qualifying private equity transactions if such offices carry on their business in Hong Kong.

## 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?**

These developments have been discussed in our responses to questions 1.2, 7.4 and 9.4.

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

There are generally no restrictions on foreign ownership of Hong Kong companies, although some restrictions may apply in certain industries (*e.g.* television and sound broadcasting).

More commonly, in FinTech or financial services-focused private equity transactions where a target portfolio company is (or has direct or indirect interest in) a business regulated by the SFC or the Insurance Authority, completion of the deal may be subject to obtaining substantial shareholder approval under the Securities and Futures Ordinance (see question 4.1), or change of control or other regulatory requirements under the Insurance Ordinance.

**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 timeframe and scope of legal due diligence as well as what is regarded as material will depend on the nature of the target portfolio company, the size of the investment and the extent to which representations and warranties may be given by the management team.

**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.)?**

A common challenge in this area is differing anti-bribery and corruption ("**ABC**") rules and regulations that may apply to a target portfolio company and the private equity investors respectively. In addition to the use of ABC warranties, common approaches to managing bribery and corruption risks include building into the due diligence process analyses on the nature of the target business, the strength of its ABC policies, and how the company obtains and retains businesses and interacts with external parties.

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

Under Hong Kong company law, the principle of separate legal personality applies. As a result, shareholders are generally not liable for the liabilities of a company.

However, where shareholders assume management responsibilities, they may be liable in the same way as directors. Equally, in cases of fraud, a court may lift the corporate veil.

## 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?**

Though the media has focused on the political situation in Hong Kong, the factors giving rise to Hong Kong's role as a major private equity hub remain intact. These factors include the legal system, the depth of professional talent and the ease of conducting business. COVID-19 restrictions rather than the political environment are key drivers affecting overall deal activity as of the time of writing.

**Timothy Loh** founded the firm and has led it as a Managing Partner since 2004. He is recognised by independent editorial publications, including *Chambers and Partners*, *The Legal 500 Asia Pacific*, *Who's Who Legal* and *Asialaw Leading Lawyers*, as a leading lawyer, including in financial markets regulation, investment funds, hedge funds, private equity, corporate law and M&A. Timothy has particular expertise advising private equity sponsors throughout a fund's life cycle and in M&A involving financial institutions, including the purchase and sale of SFC licensed corporations and IA regulated insurance companies.

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Timothy Loh LLP is an internationally recognised Hong Kong law firm focused on M&A, dispute resolution and financial services. The firm advises and represents both Hong Kong-based and international clients, including *Fortune Global 500* companies, family offices, private equity firms, hedge funds, asset managers, financial institutions and other business organisations and their key executives. It is a leader in banking, financial regulation, corporate finance, capital markets and investment funds, as measured by its rankings and those of its lawyers in leading independent editorial publications.

The firm's Private Equity and M&A practice has been recognised as a market-leading practice and its clients, ranging from start-ups to bulge bracket private equity firms, value the depth of its understanding and knowledge of the financial markets and its ability to provide creative and commercial solutions for complex and high-value transactions.

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# Hungary


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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 2021, EUR 225 million was invested into Hungarian companies through 241 transactions.

According to the annual Investment Monitoring Report prepared by the Hungarian Private Equity and Venture Capital Association in collaboration with EY, 248 investments were executed by Hungarian investors either in Hungary or abroad (1% lower than in 2020) for a total value of EUR 160 million, which represents a 7% decrease compared to 2020.

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

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

Without the virus outbreak, the balance would be quite positive for Hungary, which has already proven to be a credible and growing market for international and domestic players. The growth potential is still great in CEE and Hungary ranks among the top four countries in PE activity.

The availability of the European Union (EU) and domestic funds and their attractiveness to PE, the low interest rates and cheap financing possibilities, the booming start-up scene and the Hungarian Government have many times accentuated the drive to draw in capital to fuel the domestic economy, which keeps the interest of experienced PE investors from Europe and, especially, the United States, alive.

Hungary is becoming more attractive for investors from new regions, such as China, the Middle East and South Africa. For these third country investors, besides the general business advantages, Hungary offers free access to the EU market.

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

Further to the above, Russia's war on Ukraine has obviously already affected and will continue to effect the activity of foreign PE investors in the Eastern and Central European region. In addition to the sanction measures imposed against Russia in general, it remains to be seen whether Hungary's territorial proximity with Ukraine would add any specific negative impact on Hungary's foreign PE activity in Hungary in 2022 and onwards.

### 1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

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

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

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

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

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

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

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

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

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

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

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

## 2 Structuring Matters

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

The most common acquisition structure for PE transactions is naturally the acquisition of 100% or the majority of the target's shareholding.

In the VC market, portfolio companies are usually set-up jointly by the founders and the investors to serve as a special purpose vehicle for future investment rounds; however, in the case of more mature companies with ongoing product development and market presence, the investor may opt for a share purchase or capital increase in order to keep the brand going.

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

The main driver for the acquisition structures is to have corporate control over the target and preservation of the investors' rights. In some cases, other considerations, such as tax, have a substantial effect on structuring matters.

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

The most popular form for PE and VC investments are limited liability companies, namely "zrts", i.e. companies limited by shares, or "kfts", a companies that issue business quotas instead of shares. Business quotas have their share of limitations in terms of flexibility compared to shares, but they are still able to meet the investors' needs with regard to preferential rights associated to the investors' equity interest.

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

An investor with minority shareholding interest in general requires much stronger rights attached to its shares or business quota. Such rights embedded into the corporate structure and the underlying contractual arrangements usually take the form of a wide range of preferential rights relating to exit, decision-making, dividends, liquidation, control over the management and key employees.

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

Transactions vary in this regard, but a typical pool of shares allocated to management members and key employees (hence the term ESOP, or "Employer Stock Ownership Programme") ranges from 5–10%. Vesting under Hungarian law can sometimes be problematic and, especially for VCs, the preferred solution for ensuring management retention is the so-called reverse vesting, where the management must divest all or part of their shares if they leave the company or violate the shareholders' agreement (SHA). This is usually ensured by a call option established for the benefit of the company.

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

Good/bad leaver conditions are usually negotiated on a case-by-case basis but, in general, a management member is typically considered to be a good leaver if the employment relationship is terminated by mutual consent or unilaterally by the company, unless it is based on reasons attributable to the management member. Good leaver conditions sometimes include long-term health or family issues.

Circumstances under which a management member is considered and sanctioned as a bad leaver are obviously much broader, e.g. management members terminating their employment contract during the early years of the investment or without reasons neither attributable to the portfolio company nor the investor, or committing material breaches of the SHA or their terms of employment.

## 3 Governance Matters

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

Most of the portfolio companies operate as private limited companies (or stock companies, abbreviated as "zrt." in Hungarian) and especially in the VC sector, limited partnerships. Hungarian law enables a great deal of flexibility in terms of corporate governance for both. The three most important governance bodies of Hungarian companies are:

- the shareholders' meeting operating as the fundamental decision-making body (ownership level);
- board of directors or a single director heading the day- to-day business operation (management level); and
- the supervisory board serving as the controller of a legitimate operation.

On the ownership level, the investor, especially if in minority, generally retains the most important veto rights in material issues to ensure that fundamental decisions affecting the life of the portfolio company are adopted with due regard to the investor's interests.

On the management level, investors generally require the set-up of a board of directors, if the portfolio company does not have one already, where the investor delegates at least one board member. The board decides in every issue not specifically allocated to the scope of authority of the shareholders' meeting but even then, the board member delegated by the investor usually exercises veto rights in material issues. The board of directors' functions may be allocated to a single management member who replaces the board, but this usually does not serve either parties' interests well and it is thus a rare sight. Notwithstanding the foregoing, in some cases, investors may decide to maintain the current management structure of the company but parallelly require the set-up of a shareholders' committee, the members of which are some of the shareholders of the company, including the member delegated by the investor that exercises veto rights on the highlighted issues. Although the members of the shareholders' committee are not qualified as executive officers (managers), it should be noted that since the shareholders' committee decides on matters that otherwise fall within the scope of the management level, under Hungarian law, in cases where the company goes into compulsory liquidation, the liability of the members of the shareholders' committee shall be considered as that of the managers if they have the actual power to influence the decision-making mechanisms of the company.

On the third level, investors may require the set-up of a supervisory board if they deem it necessary, which oversees compliance with the relevant laws and internal by-laws of the company.

Corporate documents that are submitted to the court of registration are publicly accessible for anyone but there can be internal regulations and SHAs that remain hidden from the public. The drawback of such private law agreements and non-statutory regulations is that, in the case of a dispute, they can only be enforced in the civil court, which may take significant time.

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

Veto rights at both shareholder and management level are a very common tool for investors, especially investors with minority shareholding, to maintain reasonable control over the operation of the portfolio company. In recent years, *de facto* veto rights started to be replaced by a high quorum required to decide critical issues. For example, if the investor holds a 4% share in the portfolio company, then setting a minimum quorum of 96.01% means that no material issues can be decided without the consent of the investor. This is because the Hungarian competition law and the Hungarian Competition Authority (HCA) considers strong veto rights to qualify as a controlling right. If a controlling relationship exists between two or more companies, this may call for the application of the strict EU and domestic competition law and result in mandatory pre-notification or even approval to be sought by the parties. In order to avoid these costly and time-consuming procedures, both founders and investors are becoming more careful with incorporating investor rights into the corporate documents.

Veto rights and topics requiring high quorum at the most important decision-making levels, the shareholders' meeting, are usually restricted to material issues affecting the core operation of the portfolio company that can range from the most important corporate decisions (merger, transformation, liquidation, annual report) to business operation issues such as entering into high-value contracts, taking out loans and licensing intellectual property rights. There is no exhaustive list of veto rights as they are usually subject to negotiation by the investor and the founders or other shareholders.

Similar veto rights exist on a management level (usually a board of directors) where the board member delegated by the investor has the final say in crucial management decisions (ESOP, vesting, key employees, management bonus, etc.).

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

The drawback of veto rights or high quorum provisions incorporated into the corporate documents of portfolio companies stems from the relative nature of such internal regulations compared to proprietary rights that are absolute. Although corporate documents are publicly accessible, veto rights are not listed in the corporate registry that third parties rely on and third parties may presume, in good faith, that a decision adopted by the shareholders or management is valid and effective even if they have been adopted contrary to the corporate documents including veto rights.

Further limitation on the effectiveness of such veto arrangements, on either level, is the fact that any decision adopted in violation with the investor's rights must be challenged in court and such court procedures may take a long time, ranging from a couple of months to several years, even if the law provides for an expedited procedure.

These limitations cannot be effectively addressed, and investors simply must accept the associated risks and negotiate other types of insurances, for example, flip-over, call-and-put-options and other rights exercisable in case of serious violation of the SHA and/or the corporate documents.

Also, veto rights in the Articles of Association are hardcore limitations as to the business operation of portfolio companies and as already mentioned above, the HCA sees them as controlling rights under competition law, which makes the market players cautious and more inclined to resort to a softer tool (high quorum) to ensure investor rights.

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

Under Hungarian law, shareholders have a duty towards the portfolio company and not the other shareholders and even then, only to the extent of providing their respective capital contributions. Shareholders' have rights that they can exercise *vis-à-vis* the company itself or the management.

Minority shareholders enjoy special rights pursuant to the corporate laws with regard to convening the shareholders' meeting or appointing an auditor for the investigation of certain business decisions. Furthermore, all shareholders have the right to contest the validity of a resolution of the supreme body, the management or the supervisory board of a company, if the resolution violates legal regulations or the articles of incorporation of the company (with the condition that the shareholder did not approve the given resolution with its vote).

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

The enforceability of SHAs may become problematic and very time-consuming in the case of parties with different nationalities, especially outside the EU. That is why, in practice, SHAs stipulate the governing law and jurisdiction of the country where the portfolio company is seated and it is rather rare that a SHA related to a Hungarian company stipulates foreign law. Commercial arbitration, however, is much more acceptable in high-value deals and it is not uncommon that the parties submit themselves to the jurisdiction of an international arbitration court (ICC, UNCITRAL, etc.) for disputes stemming from the SHA.

The risk of unenforceability is usually addressed in the SHAs by additional insurances for the investors in case of violations, such as triggering exit rights at a given return on the investment, the flip-over of management or put/call option on shares.

Enforcing non-compete and non-solicitation obligations is especially tricky without a reasonable limitation on the affected geographic region and scope of activity. Investors run a high risk of being unable to enforce such provision against parties or activities on another continent; these undertakings are therefore usually underlined by penalty payment obligations of the infringing party.

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

There are standard conditions applicable for all board members (and management in general, altogether known as "executive officers") across all companies, regardless of nationality or whether they are delegated by an investor or not. These general requirements include being of legal age, having full legal capacity, having no criminal record and not being prohibited by court from being a management member. Special conditions may apply to portfolio companies operating in the financial sector or any other sector that requires professional expertise in certain fields.

Risks and liabilities of board members delegated by an investor are the same as any other board members: they must perform their management functions representing the company's interests; and they must comply with the internal by-laws as to procuration, decision-making and other regulated areas. However, in fact, investor-delegated members usually have less rights and information related to the portfolio company's actual operation compared to the other board members. The information asymmetry affects the position and capability of these board members, which, in turn, results in higher business risk for the investor. This is usually addressed in the SHAs through provisions granting the investor-delegated board member immunity to set off the lack of information and actual control over day-to-day operation.

The investors (or any other shareholders or third parties) themselves have no legal risk or liability related to their delegated board members, as "delegation" is not a legally regulated issue under Hungarian law. Board members are ultimately appointed by the shareholders regardless of any background deals and the shareholders are not legally liable for the appointment except under extreme circumstances where, for instance, the appointment was in bad faith or qualifies as a crime.

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

Depending on the actual transaction, a PE investor may have majority or minority voting rights in the portfolio company. In either case, the directors must act at all times by force of law in the best interest of the portfolio company, which is also in line with the PE investors' interests in the successful and profitable operation of the company so, in practice, potential conflicts of interests of this nature are rare and they are not different from general conflict of interest issues potentially arising between shareholders and management members.

Directors nominated by the same PE investor are usually not delegated to portfolio companies with competing activities, especially with regard to the small Hungarian market, and it is quite rare for a PE investor to invest in companies competing with each other.

## 4 Transaction Terms: General

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

These issues will very much depend on the industry in which the investment is taking place. In industries like banking, insurance and energy, the transfer of control over a regulated entity is subject to prior regulatory clearance. These clearance proceedings can easily take from 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 FDI regime, PE investors should be aware of the screening regulation detailed in question 1.3 above, and of Act LVII of 2018 on Controlling Foreign Investments Violating Hungary's Security Interests, which entered into force on January 1, 2019 and introduced a national security review for foreign investments in Hungary. For the purposes of the act, according to the original provisions, any natural person or legal entity registered in a country outside of the EU, EEA or Switzerland is considered a foreign investor.

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.

### 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.

**7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?**

Despite the growing trend of special purpose acquisition company (SPAC) IPOs in the EU over the last two years, it is not common practice in the Hungarian capital market to list SPACs on the regulated market; therefore, mergers with SPAC entities are not yet considered a real alternative to an IPO exit for PE sellers. In this regard, the potential challenges already arise in the first phase of the SPAC life cycle, i.e. at the time of its establishment (and listing), before the structure is even set up to a possible "de-SPAC" transaction.

Further to this, from the legal perspective, in cases where a new capital market practice is established but the relevant rules are less harmonised, such as the listing of SPACs (and their merger with target companies), the main challenge is to properly assess whether the regulatory architecture is suitable for the proposed transaction, in consultation with the competent authority and market operator, where necessary.

## 8 Financing

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

Small-cap transactions that make out most of the PE transactions on the Hungarian market are usually financed through equity but for mid-cap and large-cap transactions, cheap debt financing is available due to the Hungarian Central Bank's policy of keeping interest rates low for the past several years.

Hungary's bond market is dominated by government bonds and corporate bond issuance is scarce.

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

No special legal requirements or restrictions apply to debt financing of PE transactions.

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

Banks operating in Hungary are still offering attractive financing opportunities for PE transactions due to the low interest rates and potential buyers having access to cheap financing for various deals.

## 9 Tax Matters

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

Offshore structures are becoming less preferred due to the strict anti-money laundering rules of the EU. Ultimate Beneficial Owners (UBOs) of contracting parties must be identified in various phases of transactions by the parties' legal and financial advisors, which makes offshore companies with non-transparent owners less attractive. In addition, the anti-money laundering legislation has recently undergone a significant change in Hungary according to Act XLIII of 2021, pursuant to which, *inter alia*, the organisations that fall within the scope of the act are obliged to provide data on their beneficial owner(s), which shall be uploaded to the newly established register of beneficial owners kept by the National Tax and Customs Administration of Hungary.

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

Management participation is not that common in Hungary, but whether the sale of shares under a management participation qualifies for a tax-exempt capital gain is a case-by-case decision.

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

Since the dividend and capital gains tax form an integral part of the personal income tax regime, such kinds of income paid to a non-resident individual may be subject to personal income tax at 15%, unless the rate is reduced under the applicable tax treaty.

Private person founders or management teams resident in Hungary selling their investment should be aware of the current 15% income tax and 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.

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

A new Act on Social Contribution Tax entered into force in 2019. Since 2019, healthcare contribution has been replaced by social contribution. Under the previous regulation, a 14% rate was applied for private individuals on their capital gains and dividend income, which was increased to 19.5% but later decreased several times and is currently 13%. The current tax cap on social contribution payment is currently HUF 624,000 for the year 2022.

## 10 Legal and Regulatory Matters

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

In December 2016, the legislator introduced a new regulatory package for the establishment of PE funds, which enables an easier set-up of funds and fund managers. Unfortunately, the laws relating to PE and VC funds are still not unequivocal in certain aspects, the application thereof is not clear and the Hungarian regulator's ever-shifting practice makes the Hungarian market sometimes hard for market operators and advisors to work in.

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

National security consideration as well as anti-fraud, anti-money laundering and anti-corruption laws do not distinguish between PE investments but certain sectors, especially the financial sector, are under strict scrutiny by the competent authorities.

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

Legal due diligence is confined mostly to a red-flag type of review in smaller transactions, which concentrates on the identification of the most prevalent legal issues (corporate structure, lawful operation, capacity of management, significant contracts, employment issues, intellectual property and real estate property). Such due diligences usually take between two and four weeks depending on the availability and quality of the data room and the maturity phase of the portfolio company.

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

In line with international and EU trends, the Hungarian anti-bribery and anti-corruption laws have been becoming stricter in recent years, but we are not aware of any shift in the investors approach to PE transactions.

Anti-bribery and anti-corruption regulations are stricter in various sectors (finance, government) so market players operating within these fields are more affected if involved in PE transactions and compliance is usually checked during the legal and financial due-diligence process.

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

The Hungarian law does not distinguish between a PE investor shareholder and any other shareholder, which means every shareholder is liable for their activities as a shareholder to the same extent. The extent of liability is predominantly established by the company form in which the portfolio company operates. Due to the limited liability nature of the most common company forms (kft. and zrt.) in PE transactions, the shareholders are, in general, liable for the obligations of the portfolio company only to the extent of their own capital contribution. Under extreme circumstances, for example, when a shareholder deliberately abuses its limited liability, the limited liability is not applicable but in practice such investor behaviour is basically unprecedented.

Under Hungarian law, a portfolio company will be liable for the liabilities of another portfolio company only if there is a direct link between the unlawful conduct of these companies either through a contract or market behaviour, for example, in the case of an illegal merger. Under normal circumstances all portfolio companies, even with overlapping shareholders, will have a stand-alone liability for their own obligations.

## 11 Other Useful Facts

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

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?**

Growth, impact investments, control and buyout transactions are common in India. Despite the economic uncertainties brought on by the COVID-19 pandemic and the Russia–Ukraine war, India witnessed its highest level of deal-making in the last 12–18 months, both in terms of value and volume, with private equity ("PE") and venture capital ("VC") investments soaring and the stock market booming with blockbuster initial public offerings ("IPOs"). As per data released by the Indian government, 2021–22 reported the highest foreign direct investment ("FDI"), with FDI inflow to the tune of $83.57 billion.

In the last year, India has witnessed many investments worth $1 billion or more, such as Tata Motors' fundraising from TPG for its electric passenger vehicles segment. There has been a steady inflow of PE across sectors, with e-commerce, fintech, pharma and healthcare being some of the investor-favourites in 2021. There has also been long-awaited resolution to some of the largest distressed assets in India. While 2021 was a record-year for high IPO activity in India, volatile market conditions have resulted in a slow-down during the first quarter of 2022. However, there is a lot of interest and dry powder allocated for investments in India, with continued heightened deal sourcing and preliminary evaluation activities even in 2022.

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

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

(i) relaxations and time extensions for compliances, moratorium on insolvency proceedings, etc.;
(ii) facilitating legal and regulatory changes, such as relaxation in FDI limits and foreign exchange regulations governing inbound investments;
(iii) favourable IPO environment, tax incentives and initiatives such as 'Self-Reliant India';
(iv) India holding out as an alternative to China in the global supply chain; and
(v) multi-billion dollar exits in the past few years bolstering investor confidence.

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

(i) restrictive legal and regulatory changes for foreign investments, such as approval requirement for FDI from bordering countries; and
(ii) rising inflation and crude oil prices on account of the Russia–Ukraine war, which has currently created temporary uncertainty and volatility in connection with PE exits.

**1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

While COVID-19 has not impacted deal flow, a significant impact is the renewed focus on asset quality review and watertight documentation to provide for a pandemic-like situation. We also continue to see PE investors use compliant structures to protect return on capital and to bridge the valuation gap. Although the government's intervention in the economy and implementation of measures to combat the aftermath of the pandemic may have reassured investors, PE investments continued the upward trajectory during the pandemic due to other facilitating and influencing factors mentioned above.

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

Lately, 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 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.

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 and continued focus on best ESG practices after the investment.

## 2 Structuring Matters

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

PE transactions are typically structured as under 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 mergers, demergers 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 included as affirmative veto rights, anti-dilution rights, liquidation preference, information and audit rights, observer rights and transfer restrictions *vis-à-vis* other shareholders (by way of drag rights, right of first refusal, put options, etc.).

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

Whilst not mandatory, the management is typically allocated equity 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 cause, and where termination is undertaken in compliance with the terms of his/her employment. Contrarily, a bad leaver, leaves without notice and/or 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 changes to the business plan, acquisitions, entry into strategic partnerships, etc. Minority investors typically negotiate limited veto rights on critical matters like changes to constitution or capital structure, matters regarding liquidation, alteration of constitutional documents affecting their rights, etc. Depending on the minority position, the list of the veto rights may vary. 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 to, 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. Further, the government has recently 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 Reserve Bank of India, Securities and Exchange Board of India ("SEBI"), 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, buyers include measures for the investee company to rectify past non-compliances/regulatory lapses as pre-completion conditions to the transaction, likely affecting 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.

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

Indian law is premised on protection of interests of public shareholders and provides little protection to investors in public acquisitions. However, stringent insider trading norms and continual disclosure norms protect the investors as well. Further, for deal-protection, PE investors are known to contractually bind the investee to covenants on exclusivity, break fees, etc. Additionally, listed companies are mandated to make disclosure of material facts and events, which provides a certain degree of comfort to PE investors.

## 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 a 3–10% of 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?

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, etc.

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

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.

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

There is no general statutory obligation on PE buyers in private acquisitions to provide any financing comfort. Sellers can contractually negotiate and agree on their enforcement rights. In most cases, buyers provide fundamental warranties regarding sufficiency of funds, and provisions for funding obligation are simultaneous with the seller's obligation to transfer securities. Some sellers may insist on an equity commitment letter from PE buyers, 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 Reserve Bank of India ("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) Only such equity shares or convertible securities may be offered for sale in an IPO, which have been held by the investor for at least one year as of the date of the filing of the draft red herring prospectus.
(ii) Other than the board nomination right, no special rights such as affirmative voting matters, are permitted to continue post-listing.

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

All pre-IPO shareholders (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?

2021 was a blockbuster year for IPOs in India, with approximately 63 companies raising almost USD 1,200 billion, the highest amount ever raised in India in a single calendar 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.

### 7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?

Currently, India does not have a regime that permits the formation of special purpose acquisition companies ("SPACs") to list on the Indian markets. While SEBI had appointed an expert committee to evaluate the possibility of regulating SPACs in India, it did not gain much traction. Overseas listings through a 'de-SPAC' transaction, especially on the US markets, continues to be an option for PE-backed companies with sizeable foreign shareholding. A recent example of an Indian entity using the SPAC route to get listed on Nasdaq was the case for renewable energy giant, ReNew Power. De-SPAC transactions typically involve externalisation or cross-border mergers, which are heavily regulated in India. In addition, they come with significant taxation issues and transaction costs such as stamp duty, which makes the option less attractive.

## 8 Financing

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

Funding through privately placed 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 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 Tax Matters

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

PE investors should evaluate the tax treatment of capital gains, dividend income and interest income, and keep in mind the investment instrument employed and the jurisdiction through which the investment has been made. An offshore investor can choose between being governed by the domestic tax law or the relevant tax treaty, whichever is more beneficial. Offshore structures for investment in India are fairly common, particularly from jurisdictions with favourable tax treaties with India. 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 a commercial substance and its main purpose is to obtain tax benefits.

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

Most 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.

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

In case of a direct transfer of investments held in Indian companies, tax implications could arise in India even where such transfers are part of an internal reorganisation. In case of multi-layer offshore holding structures, gains derived from an indirect transfer of Indian assets may be taxable in India. Thus, transfer of shares or interests in foreign entities that derive their value substantially from assets located in India would be subject to tax in India even without direct transfer of Indian assets. However, certain types of corporate reorganisations, such as offshore mergers and demergers, may be tax-neutral, subject to conditions.

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

Typically, any changes in Indian taxation laws are brought about annually as part of the union budgetary exercise. Some key recent changes include the extension of tax incentives for start-ups, extension of concessional tax rate on domestic manufacturing companies, introduction of crypto taxation and discouraging non-filers of income tax returns with higher withholding tax rates. Lately, the Indian tax authorities have been examining share premiums charged by Indian companies on the allotment of shares to non-residents and are attempting to tax Indian companies on excessive share premiums.

The government has also proposed the setting-up of an expert committee to examine and address regulatory and other challenges faced by PE and VC investors.

## 10 Legal and Regulatory Matters

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

(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 recently 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) While SPAC deals are not common in India, SEBI recently appointed an expert committee to evaluate the possibility of regulating SPACs in India.

### 10.2 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.

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

PE investors usually conduct thorough legal due diligence on 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.

### 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 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.

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

While the investor may not be liable *per se*, its nominee director may be held liable for actions of the investee in his/her capacity as 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.

## 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?

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?**

In the Irish market, we predominantly see private equity (PE) transactions take the form of leveraged buyouts (LBOs), growth capital transactions, take-private transactions, bolt-on acquisitions and sponsor exits.

Irish mergers and acquisitions (M&A) activity is led by TMT (technology, media and telecommunications) and PMB (pharma, medical and biotech) transactions, alongside other high-performing sectors, including financial and business services (including insurance intermediaries) and consumer goods. We continue to see an increased presence of PE buyers (particularly UK and US) in the market, with one in every four deals reported in 2021 involving a PE fund. Perhaps unsurprisingly in a rising market in 2021, one emerging theme has been shorter PE hold times.

EY reported that, in 2021, following the COVID-19 pandemic, European PE transaction activity reached a new high – attributable to growing asset allocation towards asset classes, vast amounts of "dry powder" in the market, and sellers looking to profit from the pricing situation.

However, PWC reported that, globally, in the first half of 2022, the market slowed because of risks associated with inflation, rising interest rates, and geopolitical turmoil. Despite the turbulent geopolitical and macro-economic backdrop, EY Ireland reported that the Irish market continued to attract near-record levels of M&A activity in the first four months of 2022 (60 Irish M&A deals with a combined total of almost USD $3.3 billion in value during this period). Inbound foreign investment accounted for the majority of this activity, representing 60% of the deal count and 70% of the deal value, according to EY. In 2021, PE deals totalled €10.76 billion, a 135% increase in value from 2020; with nine (45%) of the top 20 largest Irish deals being PE transactions. As headwinds continue into H2 2022, we may see a shift to smaller bolt-on acquisitions rather than platforms transactions. However, looking forward, we expect to see a substantial number of secondary PE transactions in 2022/23, as there are currently over 150 Irish PE held assets from the first wave Irish PE transactions.

We also expect to see an increase in the level of US PE activity in the Irish market in the coming years. While large US PE sponsors have historically been active in the Irish market for larger assets, similar to the emergence of UK mid-market PE sponsor activity in the Irish market, we expect a similar expansion of the number of mid-market US PE sponsors and growth equity providers. Another trend that we see emerging, both in Ireland and more broadly, is an increase in the number of PE funds that are prepared to take minority stakes in businesses. While PE funds have traditionally focused on acquiring controlling stakes in targets, in recent years, a number of UK and US PE funds have introduced minority funds that allow them to take minority stakes in acquisition targets and, for the right type of assets, we expect to see similar opportunities in the Irish market.

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

Ireland continues to attract PE activity for a number of reasons including:

- stable political, legal, tax and economic environment;
- a low corporate tax rate – corporation tax on trading profits is 12.5% (although this is likely to increase to 15% in respect of certain organisations in due course, as Ireland is a signatory to the BEPS Pillar Two initiative – see further commentary below);
- a highly developed communications and technology infrastructure;
- young and well-educated workforce (with an increasing focus on technology as a result of the significant presence of the large tech companies in Ireland including Alphabet, Stripe, Meta, TikTok, and LinkedIn who have established their EMEA hubs in Ireland);
- availability of desirable assets within key sectoral areas of focus of PE sponsors (particularly mid-market);
- a low interest environment;
- the benefits of EU membership and of being the only English-speaking jurisdiction in the Eurozone;
- a common law jurisdiction, with a legal system that is broadly similar to the US and the UK systems;
- refundable tax credits for research and development activity and other incentives; and
- an extensive and expanding double tax treaty network, which includes over 70 countries, including the US, UK, China and Japan.

However, like other jurisdictions, the Irish PE landscape does face some challenges including:

- a contraction in globalisation and global supply-chain issues;
- the aftershocks of the COVID-19 pandemic;
- rising inflation, cost of living, energy prices (including energy supply uncertainty) and the consequences of ongoing geopolitical tensions (particularly, Ukraine); and

- the ongoing fallout of Brexit and the potential abandonment of the Northern Ireland Protocol.

### 1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

PE activity in Ireland proved resilient during the COVID -19 pandemic. Like other jurisdictions, following a reduction in activity in 2020, particularly H1 2020 as the markets got to grips with the implications of COVID-19, from H1 2021 onwards, the PE markets rebounded strongly in Ireland (and internationally). A record 240 deals for M&A, worth a total of €24.6 billion, took place in Ireland in 2021. Concerns over COVID-19 are quickly being replaced by the broader concerns noted at question 1.2 above and the risk of a recessionary environment, energy supply uncertainty and ongoing geopolitical tensions.

One long-term effect for PE is the potential implications for businesses from changes in employment practices (including remote working) and how this may impact availability of labour capital in services industries.

Like other jurisdictions, there was both financial (in the form of a range of government supports) and regulatory government intervention on foot of the COVID-19 pandemic. PE sponsors are carefully considering the implications on target financials and forecasts as the range of government support that was made available during the pandemic are stopping, with the true financial position and target health expected to become clearer in the coming months.

### 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.

Historically, there was a trend of high-net-worth individuals directly backing PE-style transactions, although these are declining and are at the lower end of the value range; however, there is perhaps growing interest from foreign family offices looking at Irish assets.

The traditional source of funding for Irish PE funds is from financial institutions, pension funds, government agencies, quasi-state bodies, overseas development funds, corporate investors, and high-net-worth individuals (as outlined above). However, following a reduction in funding from financial institutions as a result of the financial crisis, there has been an increase in the involvement of foreign sponsors and government-funded PE funds in Irish PE transactions. Typically, Irish PE funds have a term of 10 years, with the option of extending the term to facilitate liquidating the fund's interests in investee companies.

## 2 Structuring Matters

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

PE transactions in Ireland are typically structured using an Irish or 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 the 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 an Irish target, Bidco would typically be an Irish-resident limited company. However, the jurisdiction of incorporation is largely driven by tax and capital structuring considerations, although we are seeing the emergence of all Irish acquisition stacks, which is a welcome development in the market.

### 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 (e.g. maximum deductibility of interest expenses); and (iv) to allow any future sale proceeds on exit to be returned to the PE sponsor (and its investors) on exit with minimal delay.

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

A proportion of the funding committed by the PE investor to the transaction will be by way of subscription for ordinary shares in Topco. However, the ordinary shares subscribed by the PE investor typically represent only a small proportion of its funding of the transaction. The majority of the PE investor's commitment is typically funded by way of preference shares or as shareholder debt, in the form of loan notes. The combination of ordinary share capital, preference shares, and shareholder debt held by the PE investor is commonly referred to as the "institutional strip".

Management will ordinarily also take an equity piece in Topco by way of a subscription for ordinary shares, in order to ensure their interests are aligned with the PE investors. This is often referred to as "sweet 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 interests are more commonly relevant at the PE fund level than at the level of the target company and its equity structuring.

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

When the PE investor is taking a minority stake, particularly if there is no third-party debt involved, the structure of the deal may be simpler, with no Topco and Bidco stack and an investment directly into the target holding company.

A minority PE investor will typically seek the same contractual protections as a PE investor would in a control transaction, albeit their ability to dictate the same level of terms may be limited. These protections usually include tag-along rights, drag-along rights and a right to board representation, as well as veto rights over material non-ordinary course issues, including major changes to the business plan and strategy, the issuance of new equity or debt, share redemptions, acquisitions and disposals of assets, and changes to the constitutional documents. Notably, from a control perspective, a minority investor will often only have the right to appoint one or two directors, rather than the right to control the board.

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

Management would typically hold between 5% and 15% of the equity, although this will vary as between transactions.

Transaction documents will invariably include a right for the PE investor to acquire a manager's equity following the termination of his or 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.

Typically, a good leaver will receive fair market value for their vested shares, and costs for their unvested shares. A bad leaver will receive costs for all of their shares.

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, typically three to five years, following the transaction to the termination of employment. Vesting may take place on a straight-line or cliff vesting basis and would usually be accelerated in full on a successful exit.

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

The conditions for good leavers and bad leavers are transaction specific and are typically heavily negotiated on any deal. Good leavers are typically those who cease to be employed by reason of their death or disability, retirement 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. Resignation and dismissal for gross misconduct are typically bad leaver events, and any other such events negotiated on a specific deal. Additional concepts of intermediate leavers and very bad leavers are increasingly common.

Generally, the board will also have discretion to treat a management equity holder as a good leaver notwithstanding that the person does not fall within the criteria for 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?**

Governance arrangements for PE portfolio companies are typically documented in a shareholders' agreement. These agreements normally cover day-to-day management appointments and behaviour, how the business is conducted (usually through vetoes for the PE sponsor), covenants relating to management, share transfers, information rights for the PE sponsor, and raising equity and share capital.

PE sponsors also typically control the board via majority director appointment rights and/or weighted voting rights for PE sponsor directors.

The shareholders' agreement is a private document agreed between the shareholders of the PE portfolio and does not need to be made publicly available.

Additionally, the primary governance document of an Irish company is the company constitution. Certain governance controls tend to be included in the constitution, particularly in relation to transfer rights. However the constitution is a publicly filed document, so PE sponsors should be mindful of this in terms of the information included. The shareholders' agreement is the more suitable document to address sensitive or internal matters that should not be in the public domain.

**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, PE investors typically enjoy a wide range of veto rights over major corporate actions and decision making. These usually include control over the business plan and strategy, acquisitions and disposals, and major litigation, amongst others. PE investors exercise these powers through shareholder veto rights and, if available, by director veto rights through their nominee director. There is a balance that needs to be struck between the need for the PE sponsor to protect and manage its investment and control strategic issues, and the ability of management to manage the company day-to-day.

Where a PE investor 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, exit below an agreed valuation, and fundamental change of business, similar to a control transaction.

**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?**

Because veto arrangements at shareholder level are contractual rights conferred by the shareholders' agreement, they are generally upheld.

However, the Irish courts may deem such arrangements unenforceable (in whole or in part) if they: (a) unlawfully restrain any statutory powers of an Irish company; (b) have the effect of unfairly prejudicing a minority shareholder(s); or (c) are illegal or contrary to public policy.

Veto arrangements at director nominee level are also subject to the foregoing considerations. Notably, the fiduciary duty owed by directors to the company under Irish law might override, and therefore limit, the effectiveness of certain vetoes. To ensure that a director's veto is properly implemented as between the company's shareholders, the right will be typically included in the shareholders' agreement and/or the company's constitution. As a result, subject to the reservations above, veto rights can be effectively implemented between the shareholders and 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?**

As a matter of Irish company law, a shareholder does not typically owe duties to other shareholders of a company in its capacity as shareholder. However, any board nominees of the

PE investor will owe fiduciary duties to the company. In limited situations, shareholders may be able to bring derivative actions on behalf of the company against the PE-appointed directors. However, there is a very high bar to be met in order to establish legal standing to do so.

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

Shareholders' agreements relating to an Irish company are generally effective and respected under Irish law, provided that they do not: (a) unlawfully restrain any statutory powers of an Irish company; (b) have the effect of unfairly prejudicing a minority shareholder(s); or (c) are illegal or contrary to public policy.

Non-compete and non-solicit provisions will be upheld and enforced in Ireland provided that they are limited to the extent reasonably necessary in the circumstances. Any non-compete or non-solicit provisions that go beyond this and are overly broad in terms of territory, sector and timeframes, may be deemed to be unenforceable by the Irish courts as an attempt to unfairly restrict trade.

In addition, we are not currently aware of any successful derivative actions brought against PE appointed directors on behalf of the company or by aggrieved shareholders, although legally possible.

### 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?

To be eligible to act as a director of an Irish company, the director must not be: (a) under the age of 18; (b) a body corporate; (c) an undischarged bankrupt; (d) disqualified or restricted from acting as a director; and (e) already a director of more than 25 companies (unless those other companies are exempt). There is also a requirement under Irish law that at least one director must be a resident in an EEA Member State (which does not include the UK post-Brexit); however, there is a bond exemption to this if no director satisfies such requirement.

Directors of Irish companies, 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. PE investors will typically seek to mitigate the impact of this risk through directors' and officers' insurance policies.

From a practical perspective, while a PE sponsor will not incur direct liability for the actions of its appointed director, there could be in direct issues if the applicable director does not act as they would expect because they owe certain fiduciary duties to the company that would take precedence, e.g. they place the company into solvency proceedings where the company becomes insolvent.

### 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 appointed by PE sponsors do not only owe duties to the firm, but to the companies of which they are directors more generally. The Companies Act 2014 imposes a positive obligation on a director to avoid any conflict between the director's duties to the company and the director's other (including personal) interests, unless the director is released from his or her duty to the company in relation to the matter concerned. Such 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, and should be borne in mind 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. 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 constitution of the company. It is not uncommon, once such interests have been declared, for a director to remain capable under the constitution 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 the provisions of the company's constitution 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?

Irish transaction closing timetables are largely driven by regulatory approvals, most commonly merger control clearance from the Competition and Consumer Protection Commission (the CCPC) and industry-specific approvals or consents (e.g. approval from the Central Bank of Ireland (CBI) in relation to certain investments in regulated financial services businesses). Ireland is currently among the minority of EU Member States that does not conduct any screening of foreign direct investment (FDI). The impending Screening of Third Countries Transactions Bill will give effect to the EU Screening Regulation and proposes to introduce Ireland's first domestic screening regime for FDI, but we anticipate that this will not significantly delay the vast majority of M&A completions, albeit the notification and approval process will likely mean split signing and completions for a greater number of FDI transactions in Ireland.

The imposition of conditionality in relation to the acquisition of debt financing is not common in Irish PE transactions and, more generally, the parties seek to avoid conditionality in the transaction documentation to give greater deal certainty.

The prevalence of auction processes has also led to a general increase in the speed at which PE transactions are executed, with a rising number of auction processes being pre-empted by one bidder.

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

In recent years the Irish PE landscape has been increasingly favourable to sellers (both PE and non-PE), as the market has shifted towards a seller's market due to strong valuations, widespread availability of financing, and healthy competition from international and local, financial and strategic buyers.

Recent trends include: (i) an increase in the number of sale processes being run as competitive auctions on a tight timetable; (ii) an increase in the use of warranty and indemnity (W&I) insurance; (iii) shorter seller liability time periods, in many cases, regardless of whether W&I insurance is being used; (iv) fewer conditions to the completion of transactions, i.e. typically only those that are mandatory for the transaction; and (v) the use of locked-box consideration mechanics.

However, as with all trends, there are notable exceptions and PE sponsors are well placed to negotiate positions, particularly by making use of speed, commerciality and other unique advantages.

## 5 Transaction Terms: Public Acquisitions

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

Typically, PE investors will have to engage with the Irish Takeover Panel, which administers "Takeover" Rules (the statutory scheme of takeover regulations in Ireland) on public-to-private transactions. The principal purpose of these rules is to protect shareholders of the target by ensuring they are treated fairly during the course of a transaction. In order for the Takeover Rules to take effect, the securities of Irish-incorporated companies must be quoted on certain "recognised" stock exchanges. When applicable, the Takeover Rules impose a rigid framework on public-to-private transactions. Therefore, in order for a transaction to be successful, external advice is recommended. Additionally, it should be noted that there have been significant changes made to the Takeover Rules, which took effect in July 2022.

The following features of the Takeover Rules might be of particular note to PE investors:

- the timetable applicable to a takeover (tender) offer is strictly regulated. With effect from July 2022, the prescribed timetable now includes a maximum 42-day so-called "put up or shut up" period within which a potential offeror (who must be identified in any possible offer announcement issued, whether in response to rumour, speculation or anomalous share price movement or otherwise) must either issue an announcement of a firm intention to make an offer or confirm by way of announcement that it does not intend to make an offer;
- a cash confirmation that the bidder has sufficient resources available to it to satisfy full acceptance of the offer must be included in any announcement offer or any offer document where the offer is for cash or includes an element of cash. The bidder's financial adviser typically makes this confirmation and it usually means that any acquisition financing must be in place on or before the date of announcement of an intention to make an offer;
- bidders are generally bound to proceed with an offer once it has been announced. While the exact conditions to the transaction will be negotiated, there is an acceptable minimum market standard. Typical positive conditions include target shareholder approval, regulatory clearance, and any listing of consideration shares becoming effective, and negative conditions that will relate to certain circumstances not having occurred, including a material adverse change condition relating to the target business. Importantly, the Irish Takeover Panel will not allow these types of negative conditions to be invoked unless:
  - the circumstances that give rise to the right to invoke the condition are of material significance to the bidder in the context of the bid; and
  - it would be reasonable in the circumstances for the bidder to invoke the condition;
- there is a very high standard for material adverse change and scope to withdraw by invoking these conditions is limited; and
- there is a general requirement in relation to equal treatment of all shareholders, and special arrangements with shareholders will require Panel consent and may require independent shareholder approval. Management incentivisation arrangements will also typically attract additional regulatory and disclosure obligations, including Panel consultation and potentially independent shareholder approval, if advanced prior to completion of an offer. PE offerors should give early consideration to these types of matters, depending on the importance attached to securing management commitments.

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

A target company's ability to agree deal protection measures is limited by the application of the Takeover Rules. However, unlike the UK's Takeover Code, the Takeover Rules do allow for a customary non-solicit provision to be included in the transaction agreement. A break fee arrangement may also be agreed by the target company. However, the Takeover Rules limit the target break fee amount to specific quantifiable third-party costs only, subject to a limit of 1% of the value of the offer at the time of the announcement of a firm intention to make an offer payable, only where the target board withdraws or modifies its recommendation of the transaction to which the break fee relates, or where a competing offer is declared wholly unconditional or completes. In the case of two or more offerors, the aggregate value of the break fee or fees that may be paid by the target is 1% of the value of the highest offer at the time of the announcement of a firm intention to make an offer. Subject to limits in the Takeover Rules on the bidder's ability to invoke conditions, the rules are not concerned with reverse break fee arrangements, which will therefore be a matter for negotiation between the parties.

Normally, transaction documentation will also include a confidentiality agreement and a commitment to cooperate to obtain regulatory clearances.

## 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 Irish market, largely due to the ease of negotiation and the certainty they provide with respect to the final consideration paid. Combined with the shorter leakage periods being obtained by PE sponsors, 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.

Given that the current Irish market is a seller's market, "locked-box" consideration structures are commonly accepted by buyers. However, completion account structures are also commonly used, which involve a post-completion adjustment to the purchase price by reference to the working capital and/or net debt position of the target at completion as compared with an agreed target position on which the purchase price was based.

Where a completion accounts consideration structure is used, it is common to see a portion of the purchase price placed into escrow 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 or to be held as security for warranty and/or indemnity claims.

On the buy-side, PE sponsors can try to seek that a portion of the consideration is 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?

PE sponsor's will generally only provide fundamental warranties, relating to its title to shares, capacity and authority to sell. A PE sponsor will only provide business and operational warranties as to the target in limited circumstances and this is becoming rarer under the current market conditions.

Business and operational warranties are usually given by certain members of the senior management team of the target who are involved in the day-to-day running of the business and so are best placed to do so, usually given subject to relatively low liability caps. A full disclosure process will be carried out to disclose against these warranties. 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 sponsors 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); (ii) covenants to provide assistance with, and if relevant, obtain regulatory clearances/filings 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.

PE sponsors are extremely unlikely to give non-compete or non-solicit covenants, whereas it is common for exiting members of management or founders to give non-compete or non-solicit covenants where they are exiting the target business.

### 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 reducing the gap between the buyer's need for strong deal protection and a seller's desire for a clean exit free of residual liabilities. Indeed, PE sponsors will often insist as part of the transaction terms that the buyer take out buy-side insurance to cover the business warranties provided by management.

Excesses, policy limitations and pricing will differ from insurer to insurer, as well as sector, jurisdictions involved, quality of the due-diligence and disclosure process and the seller/management liability cap. Most W&I insurance policies will be subject to an excess that will ideally be set to match the aggregate liability cap of the sellers, so that, as soon as the sellers' liability is exhausted, the policy will kick-in up to relevant liability cap of the policy. The *de minimis* will typically match the deal documents. Given the recent sellers' market, sellers/management sole recourse positions (€1 caps) are becoming more common. However, with the increasing number of exclusions arising under W&I policies and a potential softening in the market this position may change. In respect of the W&I policy liability cap, price will often be a key factor, but ranges greatly from 5% to 100% of the enterprise value with insurers typically syndicating risk beyond a certain level.

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. Known liabilities or risks are also excluded from coverage. The cost of insurance would typically be between 1% and 1.5% 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?

Given that a PE sponsor's warranties will generally be limited to certain fundamental warranties as mentioned above, a PE sponsor'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 six years from closing.

Liability for leakage claims should be several and limited to leakage received by the PE sponsor itself and is typically uncapped, given that compliance with such a covenant is entirely within the control of the seller. Usually the applicable claims period is six to 12 months post-completion of a transaction.

The management team's liability for business and operational warranties is normally limited by applying an aggregate liability cap (which will depend on the transaction value and the availability of W&I insurance) and *de minimis* and basket thresholds (ordinarily set at 0.1% and 1% of the purchase price, respectively), below which no claim can be made (which can be on a "tipping basket" or "excess only" basis). Such warranties typically survive for one to three years post-closing and between four to six years for claims under tax warranties and tax covenants. Management may further limit their liability by giving the warranties on a several/proportionate basis and subject to their actual awareness; however, these limitations will be strongly resisted by a buyer.

### 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)?

Due to the increased use of W&I insurance, there is a downward trend in the use of escrow accounts; however, they are sometimes sought by a PE sponsor in respect of management warranties. Typically, escrow accounts will be strongly resisted by PE sponsors on the basis that the risk of breach for the fundamental warranties given by PE sponsors is very low and security is not therefore required. Another driving factor on resisting any retention structures is that PE sponsors want the ability to distribute full sale proceeds to their investors as soon as possible post-closing, albeit this position cuts across the buyer's position in wanting meaningful recourse with respect to warranties and indemnities. It is another reason for the increase in W&I on deals.

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

Typically, PE sponsors will provide an equity commitment letter (ECL) in respect of the equity portion of the consideration alongside a "certain funds" committed debt letter from a lender in respect of the debt portion of the consideration. In certain circumstances, sellers may request the ECL in respect of the entire consideration but this is less common (although uncertainty in debt markets may impact this in the future).

The ECL is typically addressed to the buyer's Bidco and sometimes also addressed to the sellers. The ECL provides certain covenants to fund Bidco with sufficient equity capital to cover the relevant portion of the purchase price, subject only to satisfaction of the conditions in the acquisition agreement and "certain funds" debt financing being available.

Binding finance term sheets are typically used in the debt finance aspect of a transaction. Further commitment may be given in the commitment letter by the PE fund in relation to Bidco drawing down the requisite funds under the "certain funds" debt financing. This allows the seller to enforce its rights to specific performance of this commitment letter directly against the PE fund if it fails to comply with its terms.

The seller will usually be able to enforce the equity commitment letter directly, or on behalf of Bidco, against the PE sponsor to the extent the transaction becomes unconditional and the PE sponsor fails to comply with its obligations to pay the consideration under the transaction documentation.

### 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 Irish PE 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?

Usually a PE seller in Ireland considering an initial public offering (IPO) exit will look at listing venues in Ireland, and also the UK or the US. While IPO exits have tended to achieve higher exit values for sellers, there are a number of factors, both internal and external, to consider in respect of an IPO exit, such as:

- Less control over the company – unlike private companies who have full control over the company, a public company loses some control over final decisions once the shares are made available to the public, and the original shareholders control is diluted. In addition, depending on the listing category being sought and the expectations of the sponsor or underwriter, a relationship agreement regulating the post listing relationship between a controlling shareholder (≥30%) and the company may be required to be entered into.
- Delayed Exit – the sponsor or underwriter of the IPO will typically require PE sellers to retain a holding in the company post-IPO and to enter into lock-up agreements and subsequent orderly market arrangements that restrict the disposal of the retained holding for a set period post-IPO. The PE seller will be exposed to price fluctuations during this lock-up period, which may impact on the final return to the PE seller's investors.
- High costs – IPO exists are usually significantly more costly than private sales due to the number of parties and advisers involved, how time-consuming the process is (approximately six months) and the various filing and reporting obligations.
- Loss of Privacy – a public company must make extensive disclosures about business and financial conditions, and other internal matters. These reports will also be available to a business's competitors.
- A PE seller will also need to examine the market's position before proceeding with an IPO exit, such as how big the dedicated market is and if the market is buoyant.

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

The length of any lock-up period imposed on a PE seller on an IPO exit will be determined by regulation and market practice applicable to the chosen listing venue and may be negotiated, but would customarily be for a period of at least six months from listing. Following expiration of the lock-up period, PE sellers will sometimes agree with the issuer and underwriters of the IPO to continue to be subject to "orderly market" limitations on the timing, volume and manner of the disposal of their shares. An orderly market arrangement may continue for a further period equal in duration to the 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?

PE sellers by way of IPO have not been a feature of the Irish market in recent years and almost all exits have been implemented by way of sale process. As such, there is no established market practice or pattern as regards the pursuit of a dual-track process.

**7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?**

There are no special purpose acquisition companies (SPACs) currently listed in the Irish market (with the likelihood of suspension of securities trading on announcement of a "de-SPAC" transaction being a potential impediment) but there have been a number of de-SPAC transactions involving an Irish Topco. PE sellers have not been a feature of an Irish related de-SPAC transaction to date but this remains a possibility. Potential challenges in relation to "de-SPAC" transactions include the possibility of the mandatory offer obligation under Rule 9 of the Takeover Rules being engaged. This arises where a party or parties acting in concert will hold 30% or more of the voting share capital of the relevant company (being one which is subject to the Takeover Rules). Typically, a Rule 9 waiver would be sought from the Irish Takeover Panel, a condition of which will be independent shareholder approval and an independent fairness opinion, together with publication of a circular containing prescribed information. A de-SPAC transaction may also constitute a reverse takeover, which may incur certain obligations, disclosure and approval related, under both the Takeover Rules and the listing regime of the market on which the SPAC is listed. In addition, depending on the nature of the business and its financial track record, a de-SPAC transaction may entail the necessary cancellation of listing on a regulated market and admission to a junior market, given the less onerous eligibility criteria of the later. Detailed tax analysis is advisable in connection with any de-SPAC transaction.

## 8 Financing

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

Traditional bank-led leveraged loan financing remains the most common source of debt finance used to fund both mid-market and large PE transactions in Ireland. However, in recent years, there has been increasing competition between traditional bank lenders and private credit for PE transactions. Participants in mid-market transactions have also increasingly looked to implement "unitranche" financing structures, pursuant to which traditional senior and junior debt tranches are replaced by a single tranche term facility carrying a single, blended rate of interest, usually on a floating rate. Other forms of acquisition financing such as high-yield bonds and PIK facilities have not been a feature of acquisition financings for Irish targets in recent years.

The lending arrangements may be governed by Irish law. However, for larger transactions or where the deal involves foreign lenders and/or firms, it would be more common for the lending arrangements to be governed by English law (or less commonly the laws of another jurisdiction such as New York).

Historically, parties tended to use industry standard forms to document the lending arrangements, such as the Loan Market Association's standard forms (adapted for the particular transaction). However a key change in recent years – and a function of the increased appetite of institutional investors (who traditionally invested in high-yield bonds) for leveraged loans – has led to the adoption of US "covenant-lite" and high-yield bond market terms into loans for firms acquiring larger Irish targets.

**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?**

Ireland 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 Ireland. It is typically possible for lenders to obtain comprehensive security at a reasonable cost. Upstream, downstream and cross-stream guarantee and security packages are available and widely used in leveraged financings involving Irish companies.

That said, market participants should be aware of, and ensure compliance with, any industry-specific laws and regulations, as well as the broader regulatory regime affecting PE transactions.

For example, in the current sensitive political and regulatory climate, market participants need to be especially careful with regard to compliance with anti-bribery, corruption and sanctions laws. Aside from local laws, borrowers and firms should also be aware of the expansive nature and potential extraterritorial reach of such laws and regulations in the US, which can necessitate compliance by many non-US entities (or entities that have only limited US ties).

In the context of buyout transactions of public (as opposed to private) companies in the Ireland involving debt finance, a key issue will be to ensure compliance with the "certain funds" and cash confirmation requirements of the Irish Takeover Rules. 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 have satisfied, subject to limited exceptions, the conditions precedent to the loan) at the time that the bid is submitted.

The "certain funds" concept has also increasingly permeated and become a feature of larger private buyout transactions. Although not a legal requirement in this context, in practical terms, this means that in certain private buyout transactions, lenders will be required to confirm upfront the satisfaction of all of their financing conditions and agree to disapply loan drawstop events (other than certain limited exceptions) until after completion of the acquisition.

An important difference between Irish and English law is that Ireland still retains a prohibition on financial assistance for private companies. Under the Irish Companies Act 2014, an Irish company cannot provide financial assistance (whether by loan, guarantee, the provision of security or otherwise) for the purchase of the company's own shares or shares in its holding company, unless an exemption applies or unless validated by the "summary approval procedure" (SAP). The exemptions are generally not available in the context of an LBO and so the assistance is typically validated using the SAP.

The SAP involves, among other things: (i) the directors of the company making a declaration that, in their opinion, the company will be able to pay its debts and liabilities in full as they fall due in the 12 months following the giving of the financial assistance; and (ii) the shareholder passing a special resolution giving the directors authority to give the financial assistance.

Where the company is a public company or is a subsidiary of a public company, it may not avail of the SAP. As a result in a public-to-private transaction, the lenders will typically require the public company to re-register as a private company promptly following the acquisition and then effect the SAP.

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

As mentioned above, we have seen private capital playing an increasingly important role in the financing of acquisitions of Irish targets.

In line with the increased prevalence of ESG in the wider financial markets, we have seen sustainability-linked loans being an increasing feature of buyout loans.

Like in other jurisdictions, there has been a general loosening of lending terms in favour of PE sponsors over the last few years. It remains to be seen whether terms will tighten as a result of the inflationary and interest rate headwinds that the Irish and global economies are facing.

## 9 Tax Matters

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

At a high level, the primary tax focus is to establish a tax-efficient structure and, in particular, to mitigate tax leakage on payment flows from the underlying portfolio companies through the acquisition structure to investors.

From an investor perspective, withholding tax is often a material factor. Dividend withholding tax can apply to all dividends and other distributions made by Irish resident companies to non-resident shareholders. However, a number of exemptions are available, such many non-Irish resident shareholders (both individuals and corporates) are not subject to dividend withholding tax on distributions made by an Irish tax resident company. As an example, where: (i) the shareholder is tax resident in a country in the EU or with whom Ireland has a double tax treaty in place (and not under the control of Irish residents if a corporate entity); and (ii) an appropriate declaration form is completed by the shareholder and given to the company prior to making the distribution, no dividend withholding tax obligation should arise.

Non-resident investors are generally not subject to Irish capital gains tax (CGT) on a disposal of Irish shares. A CGT withholding obligation can arise for purchasers, where they are acquiring assets such as Irish immovable property, or shares that derive the greater part of their value from Irish immovable property or mineral/mining rights. This is subject to certain monetary thresholds. In such a scenario, a vendor must furnish a purchaser with a CGT clearance certificate, or otherwise, the purchaser must withhold 15% from the sales proceeds and pay this to Irish Revenue. Similarly, a non-resident shareholder can be subject to Irish CGT, on a disposal of such assets (subject to any double taxation treaty relief).

Interest withholding tax can apply to payments of yearly interest made by Irish companies, at a rate of 20%. However, a variety of domestic exemptions and treaty relief can apply, so that withholding tax need not be operated by Irish resident companies (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 compliance with Article 4 of Anti-Tax Avoidance Directive (ATAD I) (ATAD I), Ireland has introduced interest limitation rules that will cap deductions at 30% of a corporate's EBITDA on excessive borrowing costs. In addition, anti-hybrid rules provide further limitations where there is a mismatch in the tax treatment of a payment. Certain other restrictions can also apply to intra-group lending, which can restrict deductions for borrowers and potentially, to treat certain payments of interest as distributions.

Stamp duty generally applies to the transfer of shares in Irish-incorporated companies and certain other transfers of Irish property. There are exemptions potentially available in group situations, or where certain reorganisation/amalgamation transactions take place. Stamp duty rates vary on share and asset deals from a general rate of 1% of the consideration on the transfer of shares, up to 7.5% for the transfer of non-residential property. Anti-avoidance stamp duty measures can apply where non-residential or residential immovable property is transferred and certain other conditions are satisfied (with a maximum stamp duty rate of 10% applying to certain residential property transactions).

VAT considerations can be relevant in asset transactions, specifically, where transfer of business relief does not apply and VAT is chargeable on the acquisition of the assets.

Irish transactions tend to utilise a mixture of Irish-incorporated and tax resident purchasers and non-Irish tax resident corporate purchasers. Broadly, factors such as the nature of the underlying business of the target (if a share acquisition), the nature of the assets being acquired and how the transaction is being financed can impact on whether an Irish acquirer makes the most sense from an Irish (and non-Irish) tax perspective.

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

A number of tax-efficient options are available in respect to the granting of share awards in Ireland.

There is typically no tax charge on the grant of share options (unless capable of exercise seven years or more after grant). Income tax (plus Universal Social Charge (USC) and Pay Related Social Insurance (PRSI)) can be triggered on the exercise of such options (depending on the price paid) and CGT is potentially payable on a later disposal of the shares by the shareholder.

The grant of restricted shares (shares subject to a minimum holding period) to employees and directors, is subject to income tax, USC and PRSI in the hands of the director/employee, based on the benefit to employees of the award *versus* the price paid for the shares. Depending on the required holding period, the tax charge can be reduced up to 60% (subject to clawbacks). This can function as a retention tool.

For equity investment/co-investment, subject to satisfying certain conditions, revised entrepreneur relief is available to senior management who can avail of CGT at a rate of 10% on the disposal of business assets and shares up to a lifetime limit of €1 million. Any excess over €1 million is subject to CGT at the normal rate being 33%. Broadly, relief is potentially available where at least 5% of the ordinary shares were held by the relevant qualifying individual for a continuous period of at least three years prior to the disposal.

Favourable tax treatment for carried interest is available in Ireland (a 15% personal CGT rate, compared with the general 33% CGT rate), subject to satisfying certain conditions.

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

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 any CGT reliefs, particularly for revised entrepreneur relief to apply, if potentially available.

Reorganisation reliefs are potentially available to postpone a taxable disposal occurring on a rollover of shares, as part of a reorganisation/amalgamation.

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

As is the case in most other jurisdictions, Ireland's tax rules have changed significantly in recent years in response to the OECD's Base Erosion and Profit Shifting (BEPS) project and the related EU directives, ATAD I and ATAD II.

Measures potentially impacting the PE industry include:

- The introduction of anti-hybrid rules, in response to ATAD I and ATAD II. The anti-hybrid rules potentially disallow deductions for interest and other expenses in structures involving hybrid entities or instruments (including "reverse hybrid" mismatches).
- As mentioned above at question 9.1, the recent implementation of interest limitations rules in compliance with Article 4 of the ATAD may impose a restriction on the amount of interest that is treated as deductible for tax purposes of an Irish company, restricting the amount of "exceeding borrowing costs" to 30% of earnings before EBITDA.
- Ireland substantially revising its transfer pricing rules to bring the Irish domestic regime in line with the 2017 OECD Transfer Pricing Guidelines. This change took effect for companies for accounting periods commencing on or after 1 January 2020. Irish transfer pricing rules now also apply to certain non-trading transactions and certain larger capital transactions.
- The changes to the availability of double tax treaty relief as a consequence of the adoption of the OECD's multi-lateral instrument (MLI) that overlays the application of Ireland's tax treaties with other participating jurisdictions.

Ireland is a signatory to the BEPS Pillar Two initiative, which will implement a global minimum effective tax rate of 15%. The Pillar Two measure will be implemented by way of a Directive that is currently in draft form. As currently envisioned, the 15% minimum effective corporation tax rate will only apply to multinational groups with a turnover over €750 million or more (with other Irish trading corporates generally being subject to the 12.5% headline trading corporation tax rate). No firm date for the implementation of Pillar Two has been announced.

The mandatory disclosure rules introduced by the sixth amendment to the EU Directive on Administrative Cooperation (DAC6) came into effect under Irish legislation in July 2020 and requires intermediaries to provide information in respect of certain cross-border arrangements, broadly an arrangement that concerns more than one Member State, where at least one of the hallmarks under the directive has been met. It is important to be mindful of DAC6 and the relevant filing deadlines when looking at cross-border transactions.

## 10 Legal and Regulatory Matters

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

As outlined in the previous answers to the questions in this chapter, a range of Irish and European laws affect PE investors and transactions. Among the most important of these is the Companies Act 2014, the Central Bank and Financial Services Authority of Ireland Act 2003 (providing the basic framework of law relating to financial services in Ireland), the Criminal Justice (Corruption Offences) Act 2018 (legislation aimed at prohibiting bribery and corruption by Irish businesses and individuals worldwide), GDPR (which governs the transmission and collection of data in Europe) and the Takeover Rules (referred to above).

Environmental, social, and corporate governance (ESG) matters remain high on the legislative agenda and European investors need to understand the impact of the EU's Taxonomy Regulation (EUTR), which came into force on 12 July 2020. The EUTR established a classification system listing environmentally sustainable economic activities. The taxonomy system aims to make clear to European investors that investment options are considered environmentally sustainable. The Taxonomy Climate Delegated Act (TCDA) came into force in Ireland on 1 January 2022. Its aim is to implement the EUTR by establishing criteria designed to determine whether an economic activity contributes to climate change mitigation and should be considered economically sustainable. The TCDA's main scope relates only to environmental and climate-related objectives.

The Sustainable Finance Disclosure Regulation (SFDR) has applied from 10 March 2021. It requires financial market participants and financial advisers to make pre-contractual and ongoing disclosures to end investors with regard to the integration of sustainability risks, the consideration of adverse sustainability impacts, the promotion of environmental or social characteristics, and sustainable investment. The SFDR's aim is to end attempts by financial companies to falsely brand their funds as being environmentally friendly. The SFDR's intent is to set minimum disclosure standards for PE firms, pension funds, hedge funds and asset managers in respect of all fund types.

The Investment Limited Partnerships (Amendment) Act 2020 (the 2020 Act), enacted on 23 December 2020, has modernised the ILP structure, bringing it in line with comparable partnership vehicles in other leading jurisdictions. Principally, it allows umbrella type ILPs to be formed with multiple segregated liability compartments or sub-funds. This provides asset managers with significant structuring flexibility and allows different strategies and investor types to be accommodated within one overall architecture, while at the same time preserving segregation of liability (i.e. the assets of one sub-fund are not available to discharge the liabilities of other sub-funds within the same umbrella). Importantly, the liability of limited partners (LPs) is limited to the amount they contribute or agree to contribute to the ILP unless they perform certain activities related to the management and operation of the ILP. The 2020 Act also provides a non-exhaustive list of activities that an LP can perform in relation to the ILP, which will not be considered to be participating in the management of the ILP and consequently will not compromise its limited liability status.

The Competition (Amendment) Bill 2022 (the Bill) was recently signed into law in June 2022, which gives significant and wide-ranging new powers of intervention to the Irish merger control authority, i.e. the CCPC. We have set out below some of the key amendments introduced by the Bill:

- the CCPC will be able to require parties to a below threshold deal to notify the CCPC if it thinks that the deal may have an effect on competition in Ireland. Even if such a below threshold deal is not notified to the CCPC by the parties as required by the CCPC, the CCPC can still proceed to review the deal as if it had been notified; and the CCPC can also impose interim measures. The Bill sets a potentially low "effect on competition" bar for the CCPC to be able to call-in a below threshold deal for notification;
- currently, the CCPC cannot impose interim measures in relation to notified deals; however, as a result of the Bill, the CCPC will be able to impose interim measures on the parties to primarily notified deals if there is a risk they "may have an effect on competition" in Ireland (again, a potentially low bar); and
- currently, a deal that is, or should have been, notified to the CCPC and is put into effect before it is approved by the CCPC, is void under the Competition Act 2002 (as amended). As a result of the Bill, it will also be an offence to put such a deal into effect before CCPC approval. The undertakings, or persons in control of such undertakings who knowingly and wilfully permit the breach, are guilty of the offence and are subject to fines of up to €250,000 (plus daily default fines). This change significantly increases risks for businesses that complete deals prior to CCPC approval.

These wider powers of intervention under Irish merger control are similar to the European Commission's ability to intervene under EU merger control (e.g. Article 22 of the EU Merger Regulation and interim measures) as well as the Competition and Markets Authority's wide powers of intervention under UK merger control. The compulsory notification thresholds will remain the same, being (i) a combined turnover in Ireland of at least €60 million of all parties to the deal, and (ii) each of two parties to the deal with turnover in Ireland of at least €10 million (these thresholds do not apply to "media mergers" under the Competition Act 2014).

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

PE investors are not generally subject to enhanced regulatory scrutiny in Ireland. However, transactions involving businesses operating in certain regulated sectors will be subject to additional regulatory consents or approvals. These include, amongst others, acquisitions of a qualifying holding (10% or more of the capital or voting rights or the ability to otherwise exercise significant influence over management) in firms regulated by the CBI, mergers of Irish media businesses, and acquisitions of stakes in Irish airlines that are subject to European foreign control restrictions. Public-to-private transactions also need to comply with the Takeover Rules as discussed in section 5.

Ireland is currently among the minority of EU Member States that does not conduct any screening of FDI. The impending Screening of Third Countries Transactions Bill will give effect to the EU Screening Regulation and proposes to introduce Ireland's first domestic screening regime for FDI. While the new Irish regime will be robust, we anticipate a relatively lenient approach that will not significantly delay M&A completions, albeit the notification and approval process will likely mean split signing and completions for a greater number of FDI transactions in Ireland.

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

The level of diligence conducted will vary from transaction to transaction, and will consider factors such as the nature and size of the target company, and the timeline available for diligence. Due diligence will involve a review of most legal and business aspects of the target, including (but not limited to) investigations into title, assets, material contracts, ESG, intellectual property, litigation, real estate, and compliance. These investigations tend to be conducted on an issues-focused "red-flag" basis, and to be governed by materiality thresholds aligned to the size of the deal in question.

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

Anti-bribery legislation has further increased the focus of PE sponsors on the day-to-day business activities of the targets they are acquiring, and their sensitivities to various business practices and corporate conduct. This trend (driven by the enactment of the Criminal Justice (Corruption Offences) Act 2018 in Ireland), has impacted the thoroughness of due-diligence investigations and the day-to-day governance rights insisted upon by PE sponsors. In addition, the W&I insurance policies that are very often put in place in connection with PE transactions generally exclude bribery and corruption from their cover.

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

Where the underlying portfolio companies are incorporated as limited liability companies, Irish courts will generally respect the separate legal personality of each entity and will not impose liability on their shareholders or on other companies in the group for their activities, save in very exceptional circumstances, such as where it is being used for a fraudulent purpose or to evade legal obligations. If a portfolio company is an unlimited company or partnership, its shareholders or partners can be liable for the entity's debts.

## 11 Other Useful Facts

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

As discussed above, we are seeing increasing levels year-on-year of PE sponsor activity (particularly the UK and US midmarkets) in Ireland for reasons already outlined in section 1 above and we expect this trend to continue with an increasing amount of PE sponsor exits in 2022/23.

There are no particular factors that should give rise to concern for PE investors in Ireland. As at the date of authorship, the wider economic background and geopolitical tensions present macro-economic risk globally and Ireland is not immune from those risks. As with other jurisdictions, ESG is an increasing area of focus and we expect this to continue. The expectation is that investors will soon need to integrate ESG into their investment decisions and investment strategies. The upcoming Screening of Third Countries Transactions Bill discussed above will introduce Ireland's first domestic screening regime for FDI bringing Ireland in line with other jurisdictions who already have similar legislation in place and will need to be factored into deal structures and timetables.

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A&L Goodbody LLP is one of Ireland's leading Irish corporate law firms, with over 900 staff.  A&L Goodbody's Private Equity group is recognised as the leader in Ireland.  Clients value our deep experience of acting for both PE acquirers and vendors, our sectoral knowledge and our familiarity with typical PE debt and equity financing structures.  At the group's core is a team of experts drawn from corporate, finance, funds and tax together with support from all of the firm's key practice groups.
Our corporate team works closely with our finance, tax, and funds experts and clients benefit from their combined experience and understanding of the fund-raising, fund structuring, financing, buyout and restructuring market.  ALG has extensive experience of working with the majority of the leading Irish and international PE funds (and their international lawyers) both in relation to primary and secondary transactions and across a wide range of industries.

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# Italy

Marco Gubitosi

Legance

Lorenzo De Rosa

## 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, and encompasses a significant number of global, US, pan-European and domestic private equity firms and alternative providers of private capital of different sizes and styles, carrying out most types of private equity transactions able to meet the industry different needs – as envisaged in the other sophisticated European and US private equity markets – with more than 1,200 Italian portfolio companies.

Indeed, nowadays, private equity represents a fundamental, strategic and transformative part of the Italian economy, M&A activity and financial and corporate landscape, linking worldwide-recognised Italian family-owned entrepreneurship with the global and national financial markets.

The appetite of private equity investors for the Italian market during 2021 peaked, in line with global and European trends and within the context of the wider Italian M&A bonanza, with unprecedented record levels (relative to the historical market data for the Italian private equity market) in deal value and volume as well as in the upstream fundraising activity.

Such appetite, and the ensuing transformative development of the Italian private equity market, also continued during H1 2022, which registered (unlike the wider M&A activity, which suffered a slowdown in its pace of activity relative to the frenzy of 2021) a steady and resilient flow of domestic and cross-border private equity transactions with a deal value higher than that of 2021 (although mainly due to the gigantic and outlier "*Atlantia* take-private deal" together with other seven mega deals carried out by financial sponsors), while H1 2022 deal volume registered a contraction; this is in spite of the persistence in the country of the COVID-19 pandemic, the deep escalation of the ongoing war in Ukraine, compounded by the deal-makers' worries about the deceleration of global economic growth (mainly due to the rising of energy and commodities prices, inflation, interest rates, public debts), and the disruption of the international trade activity, together with the reshaping of the current multilateralist post-cold-war world order and its ensuing de-globalisation process and clashes between democracies and autocracies.

Looking at the data, according to AIFI, the Italian Private Capital Association, during 2021, a staggering 654 transactions (approximately), involving 488 companies, were executed for the unprecedented total deal value of EUR 14.69 billion, with a remarkable increase of 39% *vs* 2020, mainly fostered by the venture capital sector with 371 transactions executed (including the relatively new niche in the Italian market of corporate venture capital). Following the 2021 momentum, Italian private equity activity in Q1 2022, despite the increasing global economic and geopolitical concerns, registered the highest Q1 performance of the last two decades through the execution of about 187 transactions (+10.7% *vs* 2021), including 86 add-on investments (which are considered strategic for the characteristics of the Italian corporate landscape) and several large and mega deals in the infrastructure sector, including the gigantic and outlier *Atlantia* deal.

In making their investments in Italy, private equity firms usually prefer to acquire the control of a target company rather than a minority stake either through: (i) the subscription of a reserved share capital increase – mainly when the target needs new equity to repay its debts or feed its development goals; or (ii) straight acquisitions of the controlling shareholding.

Moreover, during 2021, 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 104 divestments completed for a total value of EUR 2.7 billion. In the Italian market, the exit phase is traditionally predominantly carried out through the exit mechanism of trade sale (36 executed exits) and secondary sale (31 executed exits), followed by founders' and sellers' buy-back, and, to an extremely limited extent, by flotation or initial public offerings ("**IPOs**") and de-SPACs, with the remaining divestments carried out through sales to other investors and family offices, and, in some cases, write-offs or involuntary exits.

In 2021 and H1 2022, 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. However, some trends and features can be highlighted: (i) a relative increase of sale auction processes with fierce competition between financial sponsors and strategic/corporate investors; (ii) co-investments, club deals or "consortia" between private equity firms (or between private equity firms and strategic investors or State-owned or -sponsored investors) are becoming more common in Italy, in particular with regard to large or mega buyout deals in the infrastructure sector, to combine their technical skills and financial capability against a new challenging economic environment; (iii) a remarkable increase in the execution of warranties and indemnities policies within the context of buyout transactions; (iv) 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) a relative 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 landscape is generally considered by global, US, pan-European and domestic private equity firms an attractive market, characterised by a large number of potential primary transactions, relatively few sale auction processes and a vast spectrum of appealing targets, 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 globally successful family-owned companies (few listed ones) with a particular focus on exports and international markets, active in highly specialised sectors, with skilled and highly trained personnel and workforce. The "Made in Italy" brand plays a pivotal role, too.

Therefore, the Italian private equity market somewhat represents a unique and fertile land for financial sponsors, other alternative capital providers and M&A deal-makers that focus their investment appetite on both small and mid-size companies (often through add-on transactions) and large private and listed companies.

Private equity firms 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 traditionally attract most cross-border inbound investments.

Moreover, with respect to the factors that may encourage private equity transactions, it is worth emphasising that the Italian government set forth a National Recovery and Resilience Plan, mostly financed by the European recovery plan known as "Next Generation EU", which should involve funds for more than EUR 220 billion over the 2021–2026 period to boost a transformational economic change of Italy, focused on the environmental, social and financial sustainability.

In light of the above, the above-mentioned five-year period (which is the average period of a buyout investment) might be decisive for Italy to reset its political and economic institutions having as main objects: (i) the public economy handling; (ii) the public administration and civil service red-tape bureaucracies; (iii) the architecture and culture of the legal and justice system, as well as the judiciary offices; (iv) the enactment of new legislation and simplification of the existing legislation; (v) the competition; and (vi) the taxation system. The implementation of the above-mentioned plan should be carried out as originally planned, notwithstanding the current turmoil in the Italian political arena.

On the other hand, the uncertainties in the efficiency of some Italian courts and the public administration red-tape are considered by most private equity firms and investors the main factors currently limiting the actual amount of foreign direct investment ("**FDI**") in Italy, including those coming from the global private equity industry.

Finally, there is currently an abundance of private equity dry powder for investment in Italy, and buyout transactions probably will involve a reduced amount of debt finance, thus with a reduced risk for traditional banking facilities. Vast opportunities remain in place for good Italian family-owned-businesses of any size or listed companies willing to open their shareholdings to private equity investors.

### 1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

Private equity transactions are, nowadays, increasingly focused on limiting the use of acquisition finance and are based on a more moderate leverage. Such transactions, in line with the relevant global trends, are also increasingly influenced and driven by the so-called environmental, social and governance ("**ESG**") factors (which have become increasingly significant in identifying new investments in all sectors of industry and services). The rising significance of ESG is also due to the entry into force of EU regulation no. 2019/2088 and its relevant Italian regulations.

Moreover, there is a renewed positive attitude by both family-owned businesses and Italian governmental authorities towards private equity activity, which in some years might be transformational for the development of the country and for the private equity industry in Italy.

As already stated at question 1.2, the Italian government has envisaged economic and financial reforms to mitigate the effects of the COVID-19 pandemic, the economic growth deceleration and the war in Ukraine on the Italian economic, corporate and financial landscape, as well as increase the protection from foreign buyers towards specific industrial and financial sectors and the activities defined as "strategic" for the country. Ultimately, such reforms are starting to have the first, although still limited, positive boost on the overall Italian M&A activity, including private equity activity.

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

The Italian market saw the recent appearance 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 and large cross-border club deals, corporate venture capital and sovereign wealth funds.

In addition, the Italian market also experienced the rise and activism of small private equity investors (entrepreneurial club deals and other informal syndicates of investors), 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 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 9 (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 9 (Tax Matters).

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

As anticipated, private equity transactions are usually implemented by a NewCo whose corporate capital is owned – directly or indirectly through a MidCo – by a HoldCo. When the private equity fund allows management investment, usually managers participate with a small stake either in the target company, the NewCo, or the MidCo.

Carried interests are an important instrument to incentivise managers to perform, and it aligns their interests with those of the investors. The carried interests represent a share of the profits of the investment – embodied into a financial instrument – that managers receive as compensation if a targeted "threshold" return of the investment is achieved (the "**hurdle rate**"). Usually, the relevant instrument also provides for little or no governance rights and limitations on transfers. For further considerations on carried interests, please refer to section 9 (Tax Matters).

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

In case of minority investments, private equity firms – like all investors – typically seek: protections, such as veto rights/super majority provisions on certain matters (*e.g.*, extraordinary transactions, transactions with related parties, strategic decisions, etc.); the possibility to have "watching dogs" in the board of the target – or sometimes, to designate one/two director(s); preference rights on distributions and liquidation; and specific information rights on the activity of the management body of the company (with detailed quarterly or semi-annual reports).

Furthermore, minority investments entail trust in the seller who, usually, continues to manage – directly or through his/her managers – the company's business and, as a consequence, they require his/her commitment to the company for a certain time period. Therefore, it is common to see minority investors also negotiating share transfer limitations (such as lock-ups or tag- and drag-along clauses). To that end, shareholders' agreements (and by-laws provisions) play a fundamental role.

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

The typical range of equity allocated to the management is generally a small minority of the corporate capital of the target or NewCo (around 5–10% of the ordinary shares). However, should the target be a "family-managed" company, the equity allocated to the management could be higher. It is not unusual to negotiate a call option on the remaining shares in favour of the investor or a put option in favour of the management, which can be triggered upon occurrence of certain agreed events (including good or bad leaver events).

Management's ownership is also usually subject to lock-ups and other share transfer restrictions and non-compete undertakings.

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

Good and bad leaver concepts are generally taken into account to calculate the price of the management shares in case of departure of the manager.

The most common events of good leaver are death, mental/physical incapacity preventing the manager from continuing his/her office, retirement, and revocation without cause.

On the other hand, any case of revocation with just cause (*giusta causa*) usually represents a bad leaver event, in addition to other specific events negotiated by the parties. Bad leaver events usually determine a discount on the market price of the management shares.

## 3 Governance Matters

As a preliminary overview, it is worth noting that Italian companies are allowed to 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 only four Italian listed companies at the end of 2020 (*i.e.*, three companies adopted the one-tier system and only one chose the two-tier system) and, also with reference to unlisted companies, the traditional model is the most widely adopted. In light of the above, the answers below only make reference to the traditional model.

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

The governance arrangements for private equity portfolio companies depend on the type of investment. For instance:

(i) in case of minority investments, refer to the answer under question 2.4; and

(ii) in case of majority investments, governance arrangements mostly relate to the full operational management of the target. By contrast, minority shareholders would usually seek veto/super majorities for material decisions, including the possibility to designate at least one director of the board.

In Italy, there is no obligation to disclose and/or make available shareholders' agreements, save for listed companies. However, in case corporate arrangements are also reflected in the by-laws of the target, those arrangements will be publicly available (since by-laws of companies are publicly available in Italy and can be easily extracted from the Italian Companies' Register).

It is worth mentioning that, especially for joint-stock companies (whose regulation is less flexible than the regulation provided for limited liability companies), certain governance provisions agreed by the parties in a shareholders' agreement cannot be mirrored into the by-laws of the company. Also, the main difference is that while shareholders' agreements are enforceable only towards shareholders who are party to the agreement (*efficacia obbligatoria*), by-laws provisions are also enforceable *vis-à-vis* third parties (*efficacia reale*); such difference plays an obviously important role in the event of violations.

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

Unless the by-laws of a private company contain supermajority provisions at shareholders' level and/or board level, resolutions are taken by simple majority.

Generally, a private equity investor (directly or through the designated director(s)) acquiring a minority stake would seek veto rights/supermajorities on all major corporate decisions of the target either at the shareholders' level (such as extraordinary transactions, liquidation, amendments of the by-laws, capital increases, etc.) or at the board of directors' level (strategic decisions, related party transactions, important financial matters such as approval of the business plan, etc.).

Should a private equity investor acquire a controlling stake, the veto/supermajorities above are usually sought by the minorities.

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

There are no specific rules limiting the effectiveness of veto rights. Veto rights are usually provided in shareholders' agreements, enforceable as contractual obligations binding upon the contractual parties, unless they are also reflected in the by-laws – to the extent permitted by the law. However, in order to avoid serious and continuous deadlock situations (which could lead to the impossibility for the company to operate and continue pursuing its corporate purpose and, in certain extreme cases, to its dissolution), escalation procedures may be agreed by the parties. The ultimate deadlock resolution mechanism is the so-called "Russian roulette" or "shotgun" clause. This clause, which forces a shareholder to either sell its participation or acquire the participation of the other shareholder, in both cases at the price determined by the proposing shareholder, has been widely debated among Italian scholars and, recently, its validity has been confirmed by the decisions of two important Italian courts. It is worth mentioning that although such clause was not new in the Italian legal framework, its validity was specifically analysed by the Italian case law for the first time only in 2017, when the Court of Rome was called to decide upon the validity of a Russian roulette clause inserted in a shareholders' agreement. The Court of Rome declared the legitimacy and validity of the clause. Such decision was subsequently upheld by the Court of Appeal of Rome (decision dated February 3, 2020).

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

Equity investors have no particular obligations towards minority shareholders. However, in taking any corporate resolutions, the majority shareholder shall always act in good faith and pursue the corporate benefit. The majority shareholder shall not take advantage of its position (*abuso di maggioranza*). Therefore, a resolution directed only to the benefit of the majority shareholder (and to the detriment of the minority shareholder) with no corporate benefit for the company could be challenged in court for annulment (in certain cases, the minority shareholder is also entitled to receive liquidated damages).

It is worth mentioning that minority shareholders shall not abuse their position (for instance, in case the by-laws of the company provide for a veto right/supermajority in favour of the minority shareholders) or act to their sole benefit or in prejudice of the interest of the company (*abuso di minoranza*).

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

Under Italian law, the duration of shareholders' agreements is subject to certain time limits. In particular:

- with respect to joint-stock companies (*società per azioni*), save in case of joint ventures, the duration of a shareholders' agreement shall not exceed a five-year term; and
- with respect to limited liability companies (*società a responsabilità limitata*), contrary to joint-stock companies, there is no such time limit; however, the shareholders enjoy a termination right at will.

Furthermore, according to Italian law, holders of the same type (category) of shares should enjoy similar rights; therefore, it is common for joint-stock companies to provide for different categories of shares that vest different rights. This principle does not apply for limited liability companies, whose corporate capital is represented by quotas (and not by shares) and whose regulation is more flexible.

With regard to non-competition provisions contained in a shareholders' agreement, such provisions shall be limited both in terms of time and geographic area or activities.

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

First of all, directors must be entitled to serve and not fall into one of the prohibited categories set out by the law. Directors of Italian joint-stock companies can be appointed for a maximum three-year term, while no such limit applies to limited liability companies.

The by-laws of the portfolio companies could also provide for specific requirements to be met by directors. Moreover, for certain types of companies (those subject to regulatory control, such as banks and insurance companies), directors and top managers shall meet further requirements provided by applicable law (in terms of reputation, professionalism and independence).

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

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

Furthermore, it is worth mentioning that a shareholder could potentially be held liable for the underlying portfolio companies if its exercise of the "direction and coordination" activity over the controlled companies causes damages or losses to such companies. The "direction and coordination" activity over the controlled companies is presumed upon occurrence of certain conditions, such as the presence of the same members of the management bodies in both the directing company and the controlled company, the steady stream of instructions that the directing company gives to the controlled company's directors. Please also refer to the answer to question 10.5.

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

Under Italian law, there is no conflict of interest *per se* if a director is designated by a shareholder or in case a director sits on the board of different portfolio companies.

The above being said, a director shall always act in the interest of the company he/she serves, in order to pursue its corporate purpose and in compliance with the corporate benefits principle. As a matter of fact, unless specifically authorised by the shareholders' meeting, directors cannot (i) be shareholders of competing companies with no liability limitation, (ii) operate a competing business, or (iii) hold the office of director or general manager in competing companies.

When a director is in a conflict of interest (on his/her or a third party's behalf) with respect to the adoption of a certain corporate resolution, he/she shall declare and explain such conflict before the vote. A resolution passed with the decisive vote of a conflicted director can be challenged by the other directors or statutory auditors if such resolution causes damage to the company. In certain cases, the conflicted director should refrain from voting (for instance, in case the resolution concerns the director's liability).

## 4 Transaction Terms: General

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

The major issues impacting the timetable for transactions in Italy are those regarding antitrust and/or regulatory authorisations/approvals/clearances, as well as the completion of unions' procedures. In addition to the foregoing, Law Decree no. 20/2020, as subsequently amended (the "**Decree**"), introduced, also in light of EU Regulation no. 452/2019 on foreign direct investments, new rules that significantly strengthened the foreign direct investments ("**FDI**") screening regulation (so-called "golden power" regulation). In particular, the Decree, as well as its implementing governmental Decrees, significantly widened the scope of the activities and assets qualified as "strategic" under an FDI perspective, and also with respect to the following sectors: defence and national security; energy; transport; telecommunications; water management; health; management of sensitive personal data; electoral infrastructures; finance, banking and insurance; certain critical technologies and infrastructures of "hi-tech" sectors (*e.g.*, dual use, robotics, artificial intelligence, semiconductors, cybersecurity, etc.); steel industry; food safety; media and pluralism.

It is worth noting that 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.

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 notifications have been carried out, of which 277 have been declared as not subject to such regulation. The special powers were exercised in only 26 cases, the majority of which referred to 5G technology. In 2021, three transactions involving Chinese investors intending to purchase Italian companies were prohibited by the Italian Government, and in the first part of 2022, further prohibitions have been adopted against two Chinese companies and another Russian company.

## 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 for a capitalisation of approximately EUR 750 billion, as of 3 December 2021: 232 companies are listed on Euronext Milan, *i.e.*, the Italian regulated main market; 174 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 2021, with 21 tender offers mainly being launched by private equity firms or by a consortium of the same, with about 16 delistings 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 "public-to-private" 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 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 and, moreover, with the deep escalation of the ongoing war in Ukraine, 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?

In the last few years, many private equity transactions have been carried out using the locked-box mechanism. The value and use of such consideration structure is dependent upon various elements, such as: (i) the time running between the date in which the investor prices the company (usually through a reference statement, which is also subject to specific and strong warranties delivered by the seller) and the closing of the transaction; (ii) the type of financial document produced by the company/seller that the investor uses to price the business (audited financial statements *vs* financial statements *vs pro forma* balance sheet, and so on); (iii) the standing of the subject certifying or auditing such document; and (iv) the stability of the business involved (which can change materially over a short timeframe). Any difference in the relevant figures between the date in which the buyer "locked the box" (the so-called "locked-box date") and the closing date is usually treated as leakage, with certain exceptions to be agreed upon in the course of the negotiation (the so-called "permitted leakages").

The above being said, sellers typically prefer an earn-out structure consideration (which gives value to their continuing presence in the company after the sale), while buyers are more comfortable with the closing accounts structure and, to a lesser extent, the locked-box mechanism (which somehow gives certainty to the purchase price and the business acquired).

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

All sellers (especially private equity sellers) generally tend to offer a very limited package of representations and warranties: the commonly accepted representations and warranties are the "legal ones" (those referring to the ownership and title over the shares of the company subject to transfer) usually accompanied by certain limited business warranties, such as tax and labour representations and warranties. The standard duration for business warranties is up to 12–18 months.

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

In common practice, private equity sellers deliver fewer representations and warranties than an "ordinary" seller and tend to negotiate a very small indemnification cap (around 10–20%); uncapped indemnities are not usually accepted by private equity sellers.

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

When the transaction envisages a separate signing and closing, interim covenants are usually provided. Interim covenants ensure that, during the period running from signing to closing (the so-called "interim period"), the target's business is not subject to material alterations with respect to the one evaluated (and priced) by the potential buyers and it is carried out in a manner consistent with past practice. Anti-leakage provisions are common too, especially if the parties agree on a locked-box consideration structure.

In certain cases, private equity sellers may also grant indemnities in relation to specific issues identified by a potential buyer during its due diligence activity in order to mitigate any impact such issues might have on the purchase price previously agreed upon by the parties (*e.g.*, in a binding offer).

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

The use of warranty and indemnity insurance ("**W&I insurance**") used to be very rare in Italy due to the high premiums requested and the necessity to carry out a very detailed (and expensive) due-diligence exercise, as required by the insurers. However, in recent years, the trend has seen some changes, and private equity players are now much more interested in W&I insurance, which is offered by many insurers (usually through brokers).

W&I insurance policies do not cover issues identified during the due diligence process or arising from matters that have not been properly assessed or inspected in the due diligence and, of course, do not cover price adjustments. In addition, such policies do not offer coverage for certain business representations and warranties, such as environmental, compliance with law (anti-corruption), secondary tax liability, sanctions, product liabilities, balance-sheet projections, etc.

The cost of such policies depends on the indemnification cap, on the coverages sought and on other factors (such as *de minimis*, basket and so on).

It is worth mentioning that while, nowadays, these policies are often adopted in real estate transactions, their use in corporate transactions is still relatively limited, even though private equity players are becoming increasingly comfortable with them – certain private equity players also require the execution of "flip-to-buyer" W&I insurance as part of the transition package. The advantages of executing W&I insurance are still debated, mainly due to: (i) the articulated process necessary for their execution – the buyer shall indeed negotiate the representations and warranties not just with the seller, but also with the insurer (especially if the parties agree that the seller would cover certain representations and warranties not covered by the policy); and (ii) the (still) considerable costs, also considering that (1) the buyer shall bear the costs of the legal advisors of the insurer, (2) certain insurers also request a break-fee, (3) the relatively limited coverage offered (see above), and (4) the very little room that insurers leave to negotiation.

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

Sellers' indemnification obligations are always subject to (a) limitations: cap (around 10–20% of the consideration agreed); basket (around 10–20% of the cap); and *de minimis* (which is typically expressed by a number, the greater the better for the seller), and (b) exclusions, such as losses resulting from change of laws after the closing, events disclosed in the context of the due diligence (where not subject to specific indemnities) or caused by an action or omission of the potential buyer. Time limitations for general representations and warranties are in a range between 12–18 months. Private equity sellers do not usually deliver fundamental representations and warranties (usually requested by a buyer for environmental, labour and tax matters) or special indemnity provisions.

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

In case of execution of W&I insurance, private equity sellers do not generally provide any additional security. In the absence of the above policy, a corporate guarantee is generally released by the parent HoldCo (or by another company of the private equity seller's group).

Private equity buyers, on the other hand, usually request bank guarantees or the execution of escrow agreements to cover (all or part of) the indemnity cap with part of the purchase price pre-adjustment(s). The duration of the escrow usually mirrors the duration of the guarantees.

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

A private equity buyer typically delivers to the seller an equity commitment letter that commits the guarantor/sponsor (part of the buyer's group) to provide the necessary funds to close the transaction or fulfil any other buyer's monetary obligation towards the seller. Equity commitment letters usually contain the right of the seller to trigger the guarantor's obligation to provide equity, upon occurrence of certain conditions (and failure of the buyer to do so).

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

Reverse break fees are not common in the Italian market.

A break-up fee could be negotiated (but would rarely be accepted by a sophisticated seller) in the preliminary documentation of the transaction. For instance, a break-up fee can be established for the reimbursement of the due diligence costs suffered by the potential purchaser in the event of the seller's unjustified interruption of the negotiations or wilful misconduct.

## 7 Transaction Terms: IPOs

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

The exit phase is the most important for the success of a private equity investment. Exits through IPOs are often at higher multiples and at a closer market price than exits through third-party sale transactions. For these reasons, IPOs represent one of the main strategies of divestment for private equity sellers. However, exits through IPOs are subject to volatility and present other significant pitfalls. Therefore, as foreseen by the relevant Italian and European legislation (in particular, Regulation (EU) no. 2017/1129 of the Parliament and of the Council, as amended and integrated by Delegated Regulation (EU) no. 2019/980 of the Commission), the IPO prospectus contains an extensive and detailed section dedicated to risks. Usually, the prospectus distinguishes between the characteristic risks of the issuer, those linked to the sector to which it belongs and those relating to the operation itself of listing the company on the stock exchange.

Moreover, from a corporate governance perspective, the IPO process requests a sort of "transformation" of the private company into a public corporation; this usually implies an internal reorganisation, also in terms of governance, in order to allow the company to comply with the rules provided for listed entities.

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

Although the lock-up period varies on a case-by-case basis, Joint Global Coordinators usually request the sellers to abide by a lock-up period ranging from three to 12 months (starting from the IPO date). It should also be noted that the lock-up period is usually longer for SPAC IPOs, where the lock-up usually lasts until the business combination (which will generally occur within 16–18 months from the incorporation of the SPAC) is completed.

Lock-up periods are not mandated by the Italian legislation or any other regulatory body, but they are either self-imposed by the company going public or required by the investment bank underwriting the IPO request. In either case, the goal is the same: to keep stock prices up after a company goes public.

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

The dual-track process is usually pursued by private equity funds. The decision to proceed with a sale or the IPO is usually taken before the approval by CONSOB of the prospectus and ultimately depends on the price offered by the potential buyers and capital market conditions.

A dual-track exit process is usually functional to maximise the price paid to the seller(s), leading to more favourable T&Cs and assuring a greater level of execution certainty.

Dual-track strategies depend also on the portfolio company's size. Small and mid-size portfolio companies, indeed, are less prone to spend resources to concurrently prepare for both an IPO and a third-party exit.

### 7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?

De-SPACs transactions are still a relatively rare investment tool in the Italian M&A and private equity realm. However, in the coming years, Italian and non-Italian SPACs may have a more important role in the Italian investment arena than in recent years; in 2021 and H1 2022, there have been few interesting successful transactions that may unleash a more prominent role for Italian and non-Italian SPACs in Italy.

## 8 Financing

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

The structure of the financing of private equity acquisitions in Italy largely depends on the size of the transaction. In the mid-cap market, deals are generally financed through senior bank loans provided by a pool of banks or, for higher amounts, syndicated loans. The number of transactions financed by means of bond issuance (in the form of mini-bond or corporate bond) and the recourse to vendor loans is also growing.

However, in larger transactions, acquisitions are also frequently financed through a combination of senior and mezzanine debt or senior debt and bonds. Financing can include senior term and revolving debt, first and second lien debt in the form of loans or notes, mezzanine term debt, payment-in-kind loans or notes and vendor financing.

Furthermore, high-yield market is a viable source of acquisition financing; the related corporate structure, similarly to bank financing, may contemplate senior and subordinated debt components through the issuance of different types of notes, with senior secured notes eventually becoming structurally senior to the subordinated notes. Despite this, the number of acquisitions entirely funded through a high-yield bond issuance is still limited in the Italian market, but we expect a considerable increase of acquisition bond financing in the near future, in particular by means of a combination of bridge to bond senior financings granted by the arrangers for the purpose of completion of the acquisition closing and their refinancing through bond issuance.

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

The main Italian law restrictions involve financial assistance and corporate benefit issues.

Financial assistance requirements restrict Italian companies from directly or indirectly providing financial support (including in the form of granting security to acquisition lenders) to buyers in the purchase of its shares. Any loan, guarantee or security given or granted in breach of these provisions is null and void.

Although in certain cases a whitewash procedure is achievable for targets to provide immediate support in acquisition financing, generally speaking in the context of leveraged buyout ("**LBO**") transactions, any financial assistance restriction would cease to apply upon perfection of a merger between the NewCo/BidCo and the target made in compliance with Italian law provisions related to LBO mergers (which also impose to follow a specific procedure contemplating a debt sustainability test at the level of the combined entity).

In market practice, to avoid any financial assistance issues, acquisition financing is commonly structured in a combination of short-term debt granted to the NewCo/BidCo (and having a maturity in line with the envisaged timing of the merger) and long-term financing (aimed at refinancing the short-term financing at the level of the combined entity). In turn, in less complex deals, long-term financing may also be granted from day one, which will provide an early termination in case the merger is not completed by a fixed longstop date (usually set six to 12 months following the closing).

In the first phase of the financing (until merger), the acquisition debt is likely to be supported only by means of a share pledge over the NewCo, as well as by further security at the level of NewCo. In the second phase (*i.e.*, upon merger), in addition to the share pledge over the merged entity, the financing takes usually benefit from security interests created over significant assets of the combined entity.

Corporate benefit requirements impose that Italian companies, providing upstream and/or cross-stream security interests and guarantees in the interest of their parent company financing, obtain a direct or indirect tangible benefit from the secured transaction. The existence of a corporate benefit for an Italian entity is ultimately a matter of fact – rather than a legal concept – to be carefully evaluated by the management of the relevant Italian guarantor, and the guaranteed or secured amount must not materially exceed the financial capability of the Italian guarantor. The market practice has elaborated some solutions for helping directors in evaluating the existence of corporate benefit and its "translation" in the relevant financing documentation (such as, for instance, limiting the maximum amount guaranteed by an Italian subsidiary to the amount of intragroup debt received by it). Nevertheless, the existence of the corporate benefit must be evaluated on a case-by-case basis.

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

At the beginning of 2021, the expectation in relation to deal activity was robust, thanks to the abundance of liquidity provided by banks and the huge number of alternative lenders that entered the market (also thanks to recent reforms that provided new rules that expressly allowed EU alternative investment funds ("**AIFs**") to "invest" in loans – where "invest" also includes origination – subject to certain conditions, and a new favourable tax regime for foreign investors), as well as very positive borrowing conditions in terms of leverage, pricing and fees, plus the introduction of a whole range of new structures. Among them, it is worth mentioning, in the context of senior acquisition loans in the Italian market, the unitranche loans. In any case, despite the influx of alternative lenders, traditional banks continue to play a major role in the Italian market. Indeed, looking at survey results, senior-only structures are the most common mid-market debt structures.

## 9 Tax Matters

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

Different key tax and structuring considerations may come into play depending on the type of acquisition (minority *vs* 100% or listed company *vs* private).

In all circumstances, given the fairly significant amount of taxes still applicable in Italy on interest, dividends and capital gains, special attention is devoted to efficient tax structuring in order to manage those charges. Intermediate foreign (typically EU) holding or finance companies generally play an important role in this attempt. One key aspect is always ensuring maximum deductibility of interest expenses in combination with no interest withholding tax on payments to lenders. Of course, repatriation of dividends or capital gains on exit free from withholding tax are also key factors when structuring the acquisition in order to maximise return from the investments.

Recent amendments to the Italian legislation introduced a total exemption on dividends and capital gains realised by EU-based AIFs, thereby making investments in Italian targets much simpler and more efficient for those entities.

Italy is one of the few countries that introduced measures to incentivise capitalisation of companies *vs* leverage through the granting of a notional interest deduction ("**NID**"). Maximising the effect of the NID while still maintaining deductibility of the interest on the acquisition financing is key.

Another area of interest is management plans, to make sure their incentive schemes are designed to fit within the recently introduced beneficial carried interest regime.

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

Italy has only recently introduced a 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".

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

Much depends on the actual co-investment scheme but, in general, when simply selling their co-investment, management teams will seek where possible to enjoy a particular tax scheme that allows an increase in the value of the investment by paying an 11% tax on the full fair market value of the instrument. Subsequent sales would be carried out without realising any chargeable gain.

In the context of a possible reinvestment, to the extent that (i) terms and conditions of the "new" scheme are not materially different from the old 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.

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

Historically, acquisition structures have been severely challenged by the Italian tax administration on the basis of non-deductibility of interest on acquisition financing. Since 2016, certain clarifications have been released by the tax authority that have provided a much more relaxed (tax) environment for most 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.

## 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?

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.

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

Generally, Italian law does not set out any specific restrictions on the issue and transfer of equity interests, except for companies active in specific sectors where the authorisation of certain competent authorities may be required. Reference is made, in particular, to transactions involving banks and re-insurance companies as well as other financial institutions subject to the supervision and rigorous scrutiny of EU and national supervisory authorities (*i.e.*, European Central Bank, Bank of Italy, IVASS, CONSOB, AGCOM).

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

The accuracy of the due diligence conducted by private equity players depends on several factors. Generally, the due diligence exercise is very detailed, in particular if the parties decide to execute a W&I policy (since a very detailed due diligence report would be requested by the insurer). In other cases, it can be carried out at a higher level. Of course, it varies case by case, also depending on the needs of the purchaser, the size of the target, and the type of investment.

If the target is sizeable, it is common for parties to agree on materiality thresholds, in order to avoid a long and expensive due diligence activity. The magnitude of the contractual warranties plays a fundamental role in such respect: if many material warranties are previously agreed, the 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.

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

Anti-bribery and anti-corruption legislation 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).

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

A private equity investor could potentially be considered liable for the underlying portfolio companies in case of its exercise of "direction and coordination" activity.

In particular, to be held liable, a company shall exercise direction and coordination activity and act in its own or another's business interest in violation of the principles of proper corporate and business management of the controlled company. The foregoing may expose the directing company to liability for damages towards the shareholders and creditors of the controlled company.

The above liability is excluded when the damage is non-existent in light of the overall result of the direction and coordination activity, or is entirely eliminated, also further to action taken specifically for such purposes.

## 11 Other Useful Facts

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

As mentioned in the previous sections, it seems that the current economic reforms adopted by the Italian government may, on the one hand, contribute to some positive improvements in the Italian economic and business environment, triggering in the next coming years, despite the current domestic political uncertainties, public investments, incentives for private investments, research and development, digitisation and innovation, but, on the other hand, limiting the long-term structural weaknesses of Italy.

Such changes in the Italian landscape might result in a positive boost for its private equity activity, as already highlighted in the first semester of 2022. Lastly, 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 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.

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# Japan



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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.

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.

**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 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

COVID-19 exposed the inefficiencies of large conglomerates and the need to digitalise its paper-based economy. Companies needing digitalisation will continue to look to PE for their expertise in improving their business operations and to strategically expand.

The economic downturn caused by COVID-19 continues to push Japanese companies into bankruptcy, which may result in an increase in distressed M&A. This in turn will encourage "corporate revitalisation funds" that utilise debt-equity swaps and other corporate restructuring methods to revitalise such companies.

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

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 a 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 9.4.

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.

In cases of VCs, it is common to issue preferred stock to VC investors, which may give them the right to preferential dividends or a right to appoint a director.

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

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.

### 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.

### 7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?

While some Japanese investors have utilised special purpose acquisition companies (SPACs) in deals abroad, it is not a formally recognised structure under Japanese law and the current listing criteria of Japanese stock exchanges does not allow for SPAC-type structures.

## 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).

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.

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. In May 2022, we saw the first independent debt fund dedicated solely to start-ups being launched.

## 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?**

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.

**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)?**

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.

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

Capital gains tax 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.

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

The 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.

## 10 Legal and Regulatory Matters

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

In 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.

**10.2 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.

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

This 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.

**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.)?**

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.

**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?**

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.

## 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?**

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. 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.

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TOKYO INTERNATIONAL LAW OFFICE

# Luxembourg


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## 1 Overview

### 1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?

Luxembourg is one of the most pre-eminent jurisdictions globally for the structuring of private equity transactions, both in the regulated and the unregulated space. Luxembourg has developed an impressive toolbox of structuring solutions to accommodate investments in both spaces. Besides the "all time classic", the non-regulated SOPARFI (participation holding companies in any form available for commercial companies under the Luxembourg law of 10 August 1915 on commercial companies (1915 Law)), the most significant examples are the creation of the SICAR in 2004 (regulated investment company in risk capital), the SIF in 2007 (specialised investment fund, a regulated alternative investment fund (AIF) vehicle used for any type of investment, including private equity) or the RAIF (reserved alternative investment fund, not subject to supervision by the Luxembourg financial supervisory authority (CSSF), but to be managed by an authorised external alternative investment fund manager (AIFM) within the meaning of the AIFMD). On the regulated side, recent years have seen an increasing use of the RAIF.

On the unregulated side, recent years have seen an increasing use of the overhauled S.C.S. and the still relatively recent S.C.Sp. type of partnerships (LP); the latter was created in 2013 as a flexible structure without its own legal personality, similar to an English LP to accommodate investors from an Anglo-Saxon background. 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 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

Luxembourg is certainly not immune to the general trends affecting transaction activity on a global scale, such as the ongoing COVID-19 pandemic and the war in Ukraine. That said, despite the obvious effects of the COVID-19 pandemic in 2020 and early 2021, we have seen transaction activity resuming to normal, even reaching a record level in the second half of 2021. It should be mentioned that, even during the pandemic, the impact was not felt in Luxembourg as significantly as in other jurisdictions. In a survey conducted by the Luxembourg Private Equity Association (LPEA) amongst Luxembourg-based GPs and LPs in July 2020, on the back of improved visibility, the impact of COVID-19 has not worsened for 85% of respondents when compared with March 2020.

The Luxembourg government put in place several measures to support investments in Luxembourg, such as the investment aid aimed at stimulating business investments in the COVID-19 period. The Luxembourg government was granting, under certain conditions, investment aid to encourage companies in financial difficulty, following a significant drop in turnover, to carry our investments that would have been cancelled or postponed as a result of the economic crisis cause by the COVID-19 pandemic. The financial aid schemes having now expired, no significant decline in the economy generally could be observed as of the date of this publication, and certainly no impact on the private equity industry in the country itself.

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

On the regulated side, there is a tendency for the pension funds and insurance companies to become more active in the Luxembourg 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 the recent COVID-19 pandemic, 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, etc. These provisions are usually included in shareholders’ agreements or LP agreements.

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

Management equity will typically represent a small percentage of the equity and management equity holders will undertake either not to vote or to vote as the sponsor directs. The typical vesting and compulsory provisions are similar to what can be seen in other European jurisdictions, and transaction documents usually include (good leaver/bad leaver) provisions allowing the private equity sponsor to acquire the management’s equity upon termination of the manager’s employment with the relevant portfolio company. The management’s exit upon exit of the sponsor is typically ensured by drag-along provisions, combined with share pledges or call options in the sponsor’s favour. Alternatively, management equity is structured in a separate vehicle investing alongside the main acquisition vehicle, often in the form of an LP managed by the sponsor.

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

A management equity holder would typically be considered a good leaver if leaving for reasons of permanent incapacity or illness or death and, in some instances if dismissed without cause. A management equity holder dismissed for cause of resigning voluntarily would be considered a bad leaver.

## 3 Governance Matters

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

Governance arrangements such as the right to appoint nominee directors, restrictions of transfer of shares, tag-along and drag-along rights, pre-emption rights, matters requiring shareholder consent, distribution of proceeds and exit provisions, are typically part of shareholders’ agreements or LP agreements. Neither agreement is required to be made public, but as a way of easing enforcement it is common to reflect certain key provisions, e.g. those governing transfer of shares, in the articles of association of the company that are public in order to make the provisions of the shareholders’ agreements enforceable against third parties.

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

It is common to provide for veto rights for private equity investors in shareholders' agreements over major corporate actions. The scope of the veto rights will, to a large extent, depend on the overall influence, i.e. the share percentage held, with minority investors typically enjoying veto rights only over fundamental actions and less over business planning and strategy matters.

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

Veto arrangements both at shareholder level and at board level are generally effective as an expression of the prevailing principle of freedom of contract as long as they are not contrary to public policy rules in Luxembourg (e.g. by depriving a shareholder entirely of its voting rights or by completely excluding a director from board deliberations). Voting arrangements typically address these limitations by including the appropriate exceptions.

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

Private equity investors do not have any specific fiduciary duties 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. To the contrary, the directors of a Luxembourg company have the duty to fulfil their mandate in good faith and to carry out their duties in the best corporate interest of the company itself, which is not necessarily in line with, or even contrary to, the interest of the private equity investor. Moreover, the directors are bound by confidentiality duties and cannot easily disclose sensitive and confidential information related to the business of the company to the shareholders. This somewhat delicate position may, in practice, expose nominee directors to increased liability risks; generally, their obligations do not differ from those of any other director. Private equity investors are generally not liable for the acts and omissions of their nominee directors, as long as they do not interfere directly with the company's management, in which case they may be held liable as *de facto* directors.

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

Under Luxembourg corporate law, a director who has, directly or indirectly, a monetary interest that is opposed to the company's interest, is under the obligation to notify the existence of such conflict of interest to the board of directors, have it recorded in the minutes of the board meeting and refrain from participating in the deliberation with respect to the transaction in which the impacted director has a conflicting interest. Finally, the next general meeting of shareholders must be informed by the board of directors of the existence of such conflicts of interest. The fact that a nominee director is, at the same time, director of another portfolio company does not create a conflict *per se*, but the director needs to be mindful that the notion of group interest is applied very restrictively in Luxembourg and, as a general principle, only the interest of the individual company itself is relevant.

## 4 Transaction Terms: General

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

Traditionally, private equity transactions in Luxembourg do not usually require any antitrust or regulatory clearances in Luxembourg itself. However, if the transaction concerns a target in a regulated sector such as the financial sector, the approval of the regulatory authorities, such as the Commission de Surveillance du Secteur Financier (CSSF), will be required. Such approval requirements may also apply to the funding of the acquisitions of a regulated business.

However, in line with recent trends in other European jurisdictions, a bill of law (No. 7578) aiming to regulate foreign direct investments (the Bill) was introduced into the legislation process on 11 June 2020 and tabled on 15 September 2021 in Parliament. The Bill is still under review by the various stakeholders and will be subject to change; however, the current status suggests that a mandatory procedure of prior notification to, and authorisation by, the Ministry of Economy will be implemented for certain foreign investments. The Ministry will be able to scrutinise and evaluate proposed foreign investment in order to determine whether a foreign investment is likely to affect public security and public order or essential national or European interests. According to the current draft of the Bill, the Ministry will be able to impose conditions or prohibit a proposed transaction altogether if public security and public order or essential national or European interests are affected.

It is expected that the potential effects on the following elements will be particularly decisive for the Ministry's assessment:

(a) critical infrastructure, whether physical or virtual, including infrastructure relating to energy, transport, water, health, communications, media, data processing or storage, aerospace, defence, electoral or financial infrastructure and sensitive facilities, as well as land and real estate essential for the use of such infrastructure;
(b) critical technologies and dual-use items within the meaning of Article 2(1) of Council Regulation (EC) No. 428/2009 of 5 May 2009;
(c) the supply of essential inputs, including energy or raw materials, and food or health safety;
(d) access to or the ability to control sensitive information, including personal data; and
(e) freedom and pluralism of the media.

While still in its early stages, it can be expected that the foreign investment regime, once implemented, will be in line with the recent trend of renewed protectionism seen in neighbouring countries such as France and Germany, including the ability of the authorities to impose coercive measures and administrative fines up to EUR 5 million according to the current status of the Bill.

### 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 as there are very few publicly listed companies in Luxembourg that would be eligible. However, the legal and regulatory framework exists and an IPO initiated by a private equity seller would be carried out under supervision of the CSSF and subject to the provisions of the Luxembourg prospectus law.

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

A lock-up period of up to 180 days seems to be a standard period in an IPO exit in Luxembourg.

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

Dual-track exits combined with an IPO in Luxembourg are not common in Luxembourg due to the reasons set out above. As the overall number of dual-track exits involving Luxembourg entities is very small and the possible timeframe for continuing the dual track depends largely on the procedural requirements of the IPO pursued in another jurisdiction, a common standard cannot be identified at this time.

**7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?**

While Luxembourg has seen the initial special purpose acquisition company (SPAC) transactions as early as 2010, it was only in 2021 that SPAC transactions really began to gain traction in Luxembourg and a number of very significant transactions have since been observed. Luxembourg SPACs are typically not listed at the Luxembourg Stock Exchange and popular listing venues include Frankfurt, Amsterdam, New York and (NYSE and NASDAQ).

As of the date of this publication, SPAC transactions seem to face some headwinds globally and investor appetite for this type of product seems to be reduced. It can be expected that Luxembourg will follow that global trend; however, the SPAC market currently still seems to be very active in the country.

In terms of the "de-SPAC" procedure, the SPAC would typically acquire the target through the "de-SPACing" process, which can be implemented through a sale, one or more (partial) mergers, contributions or a combination the aforementioned. The transaction documentation is frequently governed by the laws of the target's jurisdiction (which in most cases is not Luxembourg) or English law.

As part of the process, the SPAC usually issues classes of shares and warrants, the former being split into listed shares and unlisted shares held by the sponsors, with a view to a potential listing upon fulfilment of certain conditions agreed by the sponsors and the investors.

Challenges involved in the set-up of SPACs and the "de-SPAC" transaction include the negotiation of, often very complex, business combination documents, combined with the corporate measures in accordance with the SPAC's governing Luxembourg and compliance with the listing rules of the different stock exchanges. Timing is also a major challenge in any "de-SPAC" transaction.

## 8 Financing

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

Traditional bank-led leveraged loan financing remains the most common source of debt finance used. Bank financing is typically sourced from outside of Luxembourg, with UK and German banks, and to a lesser extent, US and French banks, being amongst the most frequent lenders.

High-yield bonds that are usually listed on the Luxembourg Stock Exchange are another frequent source of financing.

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

There are no particular legal requirements or restrictions that would affect the nature or structure of the debt financing. There is no specific legislation regarding thin capitalisation but, generally, a debt-to-equity ratio of 85:15 is accepted by the tax authorities in Luxembourg. From a corporate law perspective, however, in dealing with debt financing, the corporate interest of the borrowing or guaranteeing company needs to be taken into account and special attention should be given to the rather restrictive rules governing financial assistance and upstream or cross-stream guarantees.

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

Luxembourg, through the law of 5 August 2005 on collateral arrangements (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.

Another aspect that is very relevant given the increasing popularity of e-money institutions in Luxembourg business, as opposed to traditional banks, is the recognition of such institutions as financial sector professionals. As a consequence, collateral can be granted over assets held with e-money institutions within the legal framework of the 2005 Law.

## 9 Tax Matters

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

The tax framework in Luxembourg is considered among the most stable and business-friendly in Europe for companies, their shareholders and their employees alike. Luxembourg is not, and does not aim to be, a tax haven, but it offers one of the most flexible and attractive tax regimes within the EU. Luxembourg has bilateral tax treaties with all EU Member States and with a number of other countries (including almost all OECD Member States).

SOPARFIs (other than LPs) 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 SOPARFIs, allowing for the exemption of many 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 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 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 only tax due is a subscription tax of 0.01% based on the quarterly net asset value of the SIF.

RAIFs are subject to the same tax regime as SIFs but can opt for the SICAR regime if the constitutive documents of the RAIF state that its sole objective is to invest in securities representing risk capital.

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

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.

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

Capital gains realised by non-Luxembourg resident managers on shares issued by a Luxembourg company are only taxable in Luxembourg if the capital gains are realised upon the disposal of a substantial participation (more than 10% over the five years prior to the date of the disposal) within six months from the acquisition of the shareholding; Luxembourg resident managers may benefit from similar exemptions.

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

As 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 shell 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.

## 10 Legal and Regulatory Matters

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

There are no specific laws or regulations applicable to the private equity investors. In structuring their deals, the private equity investors must comply with the provisions applicable in the context of corporate transactions, e.g. company law in Luxembourg, anti-money laundering laws, and the Alternative Investment Fund Manager Directive.

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

Private equity transactions are not subject to any particular restrictions; as a large part of the transactional activity in Luxembourg consists of the involvement of Luxembourg structures ultimately holding assets in other jurisdictions, specific or regulatory scrutiny often originates from such other jurisdictions.

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

Similar to other European jurisdictions, private equity investors typically conduct a relatively detailed legal due diligence. The timeframe depends on the complexity and the number of documents to be covered within the scope of the due diligence. The due diligence process is usually conducted by outside legal and tax advisors alongside the auditors conducting the financial due diligence. If the focus in Luxembourg is on the holding structure, this necessarily impacts the scope of the due diligence, i.e. due diligence will typically be limited to title, corporate governance and financing arrangements.

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

Luxembourg scored 80 points out of 100 on the 2017 Corruption Perceptions Index reported by the NGO Transparency International, making it one of the least corrupt countries in the world (ranked 9 out of 198). Anti-corruption legislation has been strong for decades and transparency has been fostered by a number of reforms over the years. In that respect, it is worth noting that Luxembourg has now largely implemented the 4th AML Directive. A private equity investor shall, throughout the life cycle of an investment in Luxembourg, comply with applicable anti-money laundering legislation. While sometimes burdensome for an investor in the context of a fast-moving transaction, the stringent AML legislation has contributed to Luxembourg's reputation as a transparent and trustworthy jurisdiction for transactions of any scale.

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

As a general principle, it is not possible for a third party to pierce the corporate veil, i.e. the liability of the private equity investors in their capacity as shareholders or limited partners of private/public limited liability companies or partnerships is limited to their contribution to the share capital of the company. However, in 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.

## 11 Other Useful Facts

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

Luxembourg has created an environment and legal framework showing a clear commitment to promote the private equity sector. Private equity firms should not face any particular issues or concerns apart from those indicated specifically in this chapter.

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Eversheds Sutherland is one of the largest full-service law firms in the world, acting for the public and private sectors. We have thousands of people working worldwide and 69 offices in 34 jurisdictions across Europe, the United States, the Middle East, Africa and Asia. Our Luxembourg office focuses on corporate clients and investment funds. We advise domestic and international clients (including large corporates, private equity houses and fund managers) on private equity transactions and M&A as well as the structuring, setting-up and organisation of all types of AIFs, UCITS funds and corporate entities. We also advise on regulatory issues relating to investment funds and portfolio managers.

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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# Nigeria

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## 1 Overview

### 1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?

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.

In spite of the worsening macro-economic indices, PE transactions in Nigeria have been on an upward trajectory, with investor activity in sectors ranging from telecommunications, banking, financial services, information technology, oil and gas, and projects, amongst others. In 2021, Nigeria reportedly received about US$904 million in investment inflow into tech-focused start-ups alone, representing close to 50% of total tech investment in start-ups across Africa. Also, data compiled by the Nigerian Investment Promotion Commission ("NIPC") covering Q1 2021 to Q1 2022 reflects a rough estimate of US$22 billion in investment inflow to Nigeria.

### 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. 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 Reconciliation 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 as the 2023 Nigerian general elections draw closer, the market will witness the customary pause caused by increased insecurity and political uncertainty.

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 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

The COVID-19 pandemic changed the manner in which PE deals were traditionally executed and whilst we are beginning to see some return to physical engagement, it appears that the market has embraced the flexibility and cost-effectiveness of pandemic period executions. The increased use of technology in PE transactions – use of virtual data room, online conferencing for negotiations and meetings, signing of documents electronically, etc. – have come to stay.

In terms of risk appetite and mitigation, there has also been a slight shift, with more risk-averse financing structures, such as convertible debt, being adopted. More pronounced, however, has been the shift in sector focus with a surge in tech-based sector investments, including fintech, agritech, mobility tech, and edutech, as well as e-commerce and logistics.

Government intervention in the Nigerian economy has come in varying forms. In a bid to cushion the impact of COVID-19, the CBN introduced credit support intervention, some of which include: (i) the NGN100 billion credit support intervention for the health sector; and (ii) the NGN50 billion target credit facility for households and SMEs, etc.

With respect to its fiscal outlook, Nigeria, in 2021, raised about US$4 billion in Eurobonds to boost its foreign reserves and stabilise the wild swings in the exchange value of the Naira, and adjusted the value of the Naira twice in 2021 from NGN379 to NGN411 and subsequently to NGN413.49 against the US Dollar. However, the pressure from negative trade balance, decline in diaspora remittances, dwindling capital inflow, and drop in crude export, amongst others, are persistently mounting pressure on the exchange rate. Furthermore, in May 2022, the CBN raised interest rates from 11.5% to 13.5%. These policy measures have had a short-term stabilising effect on the Nigerian investment landscape generally. However, it remains to be seen how long the government is able to buoy investor confidence in the immediate and long-term future.

### 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.

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 and seed capital, whilst family offices and institutional investors are more interested in growth-stage investments. 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 MSMEs can raise funds under the SEC Crowdfunding Rules and the maximum that can be raised is NGN100 million, we do not view crowdfunding as currently structured, as a viable alternative. It remains an area to be watched though, with the first set of crowdfunding platform registrations only just nearing completion.

Some of these alternative financing sources are able to 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 investee corporate entities. 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 start-ups, 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, including: control; profit maximisation; tax efficiency for investors and/or the post-acquisition group; foreign exchange ("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, 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 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 CAMA specifically sets out acts in respect of which a minority shareholder may bring an act to restrain an action by 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 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 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 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, 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. 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, 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.

As highlighted in question 3.3, 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 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 12–16 weeks; approvals from the Nigerian Exchange Group ("NGX") may take between one and two weeks; approvals from the National Insurance Commission may take between 10–12 weeks; and approvals from the Nigerian Communications Commission may take between four and six 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, particularly post-COVID-19, there is a trend towards a risk-based approach to due diligence. PE investors are also increasingly taking a minority stake in the first instance, 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, with the COVID-19 pandemic bringing to fore the impact that certain unforeseen contingencies can have on investee companies and their underlying businesses, 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 investee 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 investee 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 commonly 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 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 infrastructure and other funds are also tending towards requesting bank guarantees to secure 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 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 impacts of the pandemic on businesses may also pose challenges to a PE seller considering an IPO exit.

### 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, it is not uncommon for PE sellers to pursue 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.

### 7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?

Although the use of special purpose acquisition companies ("SPAC") entities as an alternative to an IPO exit has been on an increasing rate in the global scene, it is not generally the marketplace for PE sellers as a form of exit in Nigeria given the lack of regulatory framework for same. The SEC and the NGX, in an attempt to provide the requisite regulatory framework, recently published exposure drafts of proposed rules on SPACs. Furthermore, the lack of specific regulatory framework constitutes a major challenge when considering a "de-SPAC" transaction in Nigeria. In the interim, we expect that any "de-SPAC" transaction that is contemplated prior to the issuance of specific regulations will be implemented in accordance with the existing legal framework for mergers applicable in Nigeria.

## 8 Financing

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

Debt finance for PE transactions has traditionally been by way of external debt/leverage provided by syndicate banks, institutional financiers and a range of alternate 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, loan notes, bonds and investment in relatively high-yield instruments including treasury bills.

### 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. Nigeria also does not have specific thin capitalisation rules, although the Finance Act 2019 introduced 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, 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?

The market has seen an increase in debt financing in the oil and gas and telecoms sectors, with the international oil company ("IOC") divestments and expansion of telecoms infrastructure. There have also been a number of restructurings as borrowers struggle to repay in the wake of the COVID-19 pandemic. Borrowers searching for cheaper debt have also led to a number of refinancings. Documentation wise, a number of banks are resorting to short form documentation to reduce legal costs.

The issuance of commercial papers is also replacing equity and primary market debt issuance with over NGN150 billion in CPs listed on the FMDQ Exchange in Q1 of this year.

## 9 Tax Matters

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

The 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.

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

Management teams 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.

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

The 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.

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

The Finance Act of 2021 took effect on January 1, 2022. Below are the relevant changes that pertain to PE transactions in Nigeria:

- CGT at 10% is chargeable on the disposal of shares worth NGN100 million or above in any 12 consecutive months, except where such proceeds are reinvested in the shares of any Nigerian company.
- FIRS may assess tax on the turnover of a foreign digital company involved in transmitting, emitting, or receiving signals, sounds, messages, images, or data of any kind, including e-commerce, app stores, and online adverts. Such companies are also obliged to charge, collect, and remit VAT to FIRS.
- FIRS may assess Non-Resident Companies ("NRCs") with a digital significant Economic Presence ("SEP") in Nigeria to tax on a fair and reasonable percentage of their turnover attributable to the SEP, in the instance where there is no assessable profit, or the assessable profit is less than what is to be expected from that type of business or cannot be ascertained. Based on the current rules, NRCs with a SEP on digital services are to file their tax returns on the normal/actual profit basis, that is, in line with the applicable statutory provisions on submission of corporate income tax returns.
- A restriction has now been placed on the claim of capital allowances on a Qualifying Capital Expenditure ("QCE") to the extent that such asset is employed in generating taxable profits. Also, for small and medium-sized companies, any unabsorbed capital allowances at the end of a tax year are to be deemed fully absorbed in such year. Based on this amendment, capital allowances claimable on QCE utilised for generating taxable and non-taxable income shall be prorated such that only the portion relating to taxable income should be allowable as tax relief. However, full relief should be granted where the proportion of non-taxable income does not exceed 20% of the company's total income.
- Extension of the coverage of the reduced minimum tax rate of 0.25% by one year, to include the financial year 2021. As such, a company can elect to apply the reduced minimum tax rate to any two consecutive years between January 1, 2019 to December 31, 2021.
- Companies in the upstream sector are mandated to comply with VAT, regardless of the turnover amount, as the exemption provided in Section 15(2) of the VAT Act is no longer applicable to them.
- Companies engaged in educational activities are now subject to corporate income tax, regardless of whether such activities are of a public character.
- A science and engineering levy of 0.25% of profit before tax is payable by companies engaged in banking, mobile telecommunication, ICT, aviation, maritime, and oil and gas with a turnover of NGN100 million and above.

## 10 Legal and Regulatory Matters

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

Yes. The last few years have seen a plethora of regulatory interventions, particularly in the financial services sector and in competition and merger control. Some of such developments include:

- 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 2019–2021 have also impacted PE investment, particularly exemptions to the excess dividend tax rule. (Please also refer to the response to question 9.4.)

### 10.2 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.

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

This is 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.

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

Yes. Legislation impacting PE investment includes the CAMA, 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/KYC/Integrity due diligence is also a more common phenomenon in PE transactions.

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

Generally, 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.

## 11 Other Useful Facts

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

One of the 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 have been slow to yield, it is expected that once properly implemented, the same will address the restrictions that have made it difficult to scale regionally.

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BANWO & IGHODALO

# North Macedonia


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## 1 Overview

**1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?**

Given the size and structure of the Macedonian private equity (PE) market, traditional transactions consisting of purchasing the share capital or assets of a local target continue to prevail over transactions that involve public takeovers of listed companies, which are not particularly common in North Macedonia. Recently, transactions that include minority investments and joint ventures have also become popular. Following the COVID-19 pandemic and economic slowdown, 2021 marks a significant increase in recorded investments in North Macedonia. The foreign direct investments in particular have marked significant growth, reaching EUR 512 million in 2021, which is a huge increase compared to the EUR 201 million in 2020. The IT industry has been notably dynamic and has been continuously growing the past few years, particularly since the start of the COVID-19 pandemic.

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

One significant factor encouraging PE transactions is the fact that North Macedonia has a fairly simple, fast and efficient administrative environment for business; namely, a combination of conducting equity transactions efficiently and administrative costs being relatively low. The corporate taxation system offers a flat rate tax of 10%. Also, the legal treatment of foreign investors is equal to residents in every field.

The Macedonian market is due to become attractive in the near future, as in July 2022, North Macedonia officially began the membership negotiation to join the EU and will therefore be able to offer the EU standards and environment for doing business once it has become a member.

**1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

The COVID-19 pandemic initially caused disturbance in the economy in every sector. The state has adopted several packages of measures, generally with short-term effects and as strictly emergency aid for the sectors affected the most, rather than as an investment type. The results of 2021 showed growth compared to 2020; however, after some general relief of global COVID-19 restrictions during 2022, COVID-19 unfortunately returned at full force in mid-2022, making it difficult to estimate the long-term effects of the pandemic on the North Macedonia PE market at this time.

**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.**

With the exception of traditional PE and venture capital investors, no other types of investors executing PE-style transactions are notable on the Macedonian market.

## 2 Structuring Matters

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

Investors can acquire shares in local companies either directly or by creation of an investment vehicle in a jurisdiction that has a stable and flexible corporate regime, but also has a double taxation avoidance agreement with the Republic of North Macedonia. Usually, one of the parties in the transaction is a foreign entity and they prefer to complete a deal by creating a special purpose vehicle (SPV), which will hold the shares in the Macedonian target and close the deal outside of North Macedonia, rather than acquiring the shares directly in the Macedonian target. This structure is especially useful when there is more than one investor in the investee company, whereby all the investors acquire shares in the investment vehicle company, which in turn wholly owns the investee company.

In cases where the transaction is financed by a bank loan, the target company usually accedes the financial documents and provides security instruments or guarantees to secure the acquisition debt, on or post closing.

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

There are few types of reasons why such structures are preferred. One of them is for tax purposes. On the other hand, as the Macedonian law and courts have exclusive jurisdiction in transactions related to the acquisition of shares in local companies and their registration in public registers, the parties (non-residents) thus usually prefer to avoid Macedonian law as governing law and Macedonian courts' jurisdiction. Another driver is the fact that the local corporate law regulations are fairly strict and investors prefer to have more freedom in potential sales, pledges or other activities involving the shares.

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

The most common form of equity in North Macedonia is a limited liability company, which is known as "ДОО" in the local language.

When the transactions allow management investment, managers are usually offered an opportunity to participate with minority shares in the mother company of the local target, as including management in the local company's shareholder structure is not common in North Macedonia. The participation in the mother company shareholder structure by the management of the local company is associated with achieving results in the local company.

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

When acquiring minority share interest that is not sufficient to block the decisions of the majority investor, the minorities usually tend to have some "veto" rights in respect to certain business decisions or dilution in case of capital increases, and all such protections of minorities shall be properly included in the shareholders' agreement before closing.

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

The range of equity allocated to management varies from case to case; however, the majority would prefer to not grant more than 5–10% of the shares to the management, as by such portion the management could not block the decisions of the majority shareholder(s). Practising management incentive plans, where local management attain shares in the foreign mother company, are becoming more common in North Macedonia, although there is still no specific regulation on these matters, and local companies simply follow EU practice or share bonus plans of their international mother companies. Vesting periods can vary, depending on the terms and thresholds for exercising the share options.

With regard to compulsory acquisitions, provisions may be in the form of exclusion of the management equity holder. The method for completion is at the discretion of the shareholders. In such a case, the articles of association must stipulate the conditions, procedure and consequences of the exclusion, i.e. compulsory acquisition.

It should be noted that, if the manager refuses to voluntarily accept a compulsory acquisition, the matter must be resolved by the courts and therefore the enforcement of the compulsory acquisition would be blocked or postponed.

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

Good and bad leaver scenarios are generally defined in the context of the management rights to exercise share options or the shareholders' rights to buy out the management shares, including to determine the share price in case of the exit of the management.

A good leaver scenario would involve the death of the management or losing business capability, while a bad leaver scenario is when a manager leaves a company without a justified reason or is dismissed due to bad performance.

## 3 Governance Matters

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

One EP company is usually governed by the articles of association and internal regulation documents, such as decisions of shareholders and management/supervisory bodies. These prescribe rights to fill management/supervisory positions, rules and procedures for selling shares, grounds for exclusion and reporting rights. Managerial agreements might regulate specific rights, duties and incentives of managers. Of the enumerated documents, only the articles of association are publicly accessible to anybody through an excerpt from the Trade Registry.

Governance arrangements can be made with inter-shareholders' agreements without the need to include such arrangement in the articles of association of the company, which are public; however, these would have effect for only the involved shareholders and not any third parties.

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

Unless the shareholders have not agreed otherwise and stipulated a specific majority threshold in the articles of association, the decisions are adopted by simple majority. Specific majority thresholds are compulsory for transactions considered to be significant for the company in comparison to the company's assets and transactions with interested parties.

Minority investors and their director nominees would usually negotiate and seek veto rights for major corporate decisions such as related party transactions, changes to the articles of association, liquidation of the company, deals involving a significant amount of share capital and other similar situations, on the basis of the law itself.

Veto rights must be clearly defined within the articles of association of the company and as such will have an *erga omnes* effect, or within a separate shareholders' agreement that have *inter partes* effect only.

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

There are no limits to the effectiveness of any veto arrangements, at either the shareholder level or at director nominee level. For the shareholders' level, the law stipulates that there are certain minimum support majorities necessary for certain decisions to be made; however, it is clearly stated that the shareholders can arrange for higher majorities for different situations if deemed appropriate. On the management level, allocation of blocking rights may be done with the articles of association or the decision for appointment of the individual's position holder.

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

There are no specific statutory duties owed by a PE investor to minority shareholders.

Minorities who hold at least 10% of the shares have the right to appoint an authorised auditor to perform a special audit of the last annual account and financial statements, which majorities are obligated to permit.

Majority shareholders are not allowed to make decisions under which only they will benefit, or resolve PE transactions with the shareholder; otherwise, the minority may challenge such decisions.

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

Even though the law gives flexibility for regulating the shareholders' relations and manager or supervision matters with the articles of association, the mandatory provisions of the law still limit this freedom. The same is relevant for decisions made by the shareholders. Any shareholder, management or supervisory body member, as well as any third party that has a legal interest, may submit to the court a request for a judicial revaluation of the content of the articles of association and any other general acts or corporate decisions.

Macedonian law is the exclusive governing law and the courts of North Macedonia have exclusive jurisdiction in the case of disputes arising from the establishment, termination and status changes of trade companies, whose registered seat is within the local jurisdiction.

Non-compete clauses are enforceable, as both elements of the articles of association, but also on the basis of statutory provisions themselves. In general, they are binding for the duration of the relationship between the parties (company and management). Under the employment law, one can extend the duration of the non-compete clauses for two years after the termination of the relation for any employee.

Non-solicit provisions are generally allowed and enforceable, unless they go against some mandatory regulatory provisions, such as those deriving from competition protection law.

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

All nominees for any managerial or supervisory position must fulfil the general criteria from the Law on Trade Companies. The following cannot have the quoted positions: (a) founders or members of a managing or supervisory body of a company whose bank accounts have been blocked or are under a bankruptcy procedure; (b) persons who have a prohibition for conducting an activity, profession or duty; and (c) persons convicted by a final judgment that they committed the crime of fake bankruptcy, bankruptcy with dishonest activity, and damaging or preferring creditors.

Nominees for any managerial or supervisory position in some industry branches may be required to have additional education, work experience or other qualifications in order to be able to hold those positions. The risks and liabilities of directors are the same no matter if they are nominated by a PE investor or other shareholder. The managers are: (i) responsible for the compliance of the company with the applicable laws; (ii) obliged to act with due diligence in the best interest of the company and in accordance with their authorisations provided in the articles of association and shareholder resolutions; (iii) restricted from being involved in activities that are computing the business of the company, without shareholders' approval; and (iv) not to act in a way that would be a conflict of interest with 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?

All shareholders holding more than 20% of the shares or persons holding managerial or supervisory positions must inform the managerial or supervisory organs and shareholders of any potential conflicts of interest by disclosing: (i) the ownership or control of 20% or more the shares/voting rights in any third company; (ii) third companies in which they have a managerial or supervisory position; and (iii) all current and possible deals in which they might be an interested party.

Each transaction involving any of the parties described above shall be subject to approval in a special procedure prescribed by the Macedonian law.

In addition to such information obligations, the holders of managerial or supervisory positions face prohibitions for competition, i.e. engage in the same activity themselves or are members of management or supervisory bodies in any competitor companies.

Normally, the shareholders or the managerial or supervisory bodies can approve such activities if they do not deem them detrimental to the interests of the company.

## 4 Transaction Terms: General

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

In general, once the share purchase terms are agreed by the parties, the implementation of equity transactions is fairly simple and quick to complete in North Macedonia. Any extension of the timetable of the transactions will depend on the specifics of some industry or regulated business activity, such as finance, pharmaceutical, energy and similar. Thus, in some fields, prior approval is needed in order to change the owner of the shares, while for others, only a notification will suffice.

In terms of antitrust regulations, there might be an obligation to notify the authorities and seek a concentration clearance if the merger filing thresholds under the local law are met with the transaction. However, the legal term of issuance of a merger clearance after filing a complete application is 25 business days, which is relatively short term, and the competition authorities in North Macedonia are quite efficient in respect of timing.

Foreign direct investment regimes provide an obligation to register the investment within the FDI Registry after the closing of the transaction; however, it simply involves filing a notification in prescribed form and no approval is required.

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

North Macedonia is following the trends of the neighbouring countries and wider EU jurisdictions; however, considering the size of the market, the economy level of the country and the number of transactions executed on local market, it is difficult to recognise specific trends. Local lawyers are moving away from the traditional local law forms of contracts and ways of conducting transactions and being increasingly encouraged to implement approaches and practices that are common in EU jurisdictions.

## 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 uncommon and difficult to spot in this jurisdiction. However, there is a Law on the Takeover of Joint Stock Companies, which regulates such transactions.

It should be noted that when one entity, either alone or together with other entities with which it acts, acquires 25% of the voting-rights-stocks in publicly listed company, it is obliged to provide a public offer to buy out the remaining stock. There are, however, some exceptions to this obligation listed in the law.

It should also be noted that when an offeror has acquired 95% of the voting rights stocks, it may give a public offer to buy out the rest of the stocks and the minority shareholders must sell their stocks (squeeze-out option).

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

Public acquisitions are strictly regulated and there are few options for manoeuvring. In cases of voluntary and mandatory takeover offers, the price is set by the offeror. However, there are mechanisms established by the law used for determining the minimum price per stock, which aim to protect the interests of minority shareholders. It should be noted that the offered price must be same for all stockholders.

## 6 Transaction Terms: Private Acquisitions

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

The particular type of structure PE investors prefer depends on the gap between closing and signing, necessary approvals and the business field. PE sellers would prefer a locked-box structure, which enables fixing the sale price on the signing, while buyers would prefer an adjustment on closing, particularly if it is agreed to happen some time after signing.

### 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?

Negotiating warranties and indemnities is usually the most time-consuming matter in M&A transactions. Sellers are always intending to limit the warranties to good standing and facts that may be easily verified by public registries or specific documents, while the buyers intend to have as wide a scope of warranties as possible, such as compliance with all applicable laws. A standard list of warranties relates to good standing, licences, real estate ownership, IP, material contracts, taxes, employees and litigations. Ultimately, irrespective of the package of the warranties, the indemnities are of importance, namely the cap indemnity and the minimum threshold to be met in order for the indemnities clause to be activated.

### 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 parties may agree to pre-closing as well post-closing covenants. The most common sellers' post-closing covenants and undertakings are non-competition and non-solicitation for limited time of period, while the buyers' covenants usually depend on the type of business; sometimes, post-closing buyers' covenants may relate to rebranding, termination of certain IP rights or entering into transitional service agreements, etc.

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

The insurance market is very conservative and complex insurance products for corporate representations or warranties are not yet common on the Macedonian insurance market. Complex and substantial investments for equity in North Macedonia, which incorporate representations or warranties insurance, are usually negotiated outside of this jurisdiction.

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

The limitations for warranties, covenants, indemnities and undertakings of the seller and management team usually relate to: (i) the time limitation to bring claims; (ii) the cap of the total indemnities; (iii) the minimum threshold for bringing claims; (iv) the exclusion of claims caused by acts or omissions of the buyer post-closing; and (v) no liability for amounts covered by insurance, etc.

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

Sellers would normally resist from providing security for the established warranties and liabilities and, if such is still required, would prefer to give corporate guarantee instead of cash on escrow accounts, especially if the time limitation of the indemnities is longer. On the other hand, the buyers would insist on having such security and bank guarantee or escrow accounts would be the favourable type of security. Still, if the bank guarantee or escrow account is provided by the seller, the terms and procedure of enforcing such security will be very narrowly negotiated.

### 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 usually provide a comfort letter or commitment letter by the sponsor of the buyer if it is an SPV, on the availability of the funds for the purchase price, while, in the case of debt financing, a confirmation letter of the banks on the availability of a loan can be required. In the case of absence of compliance by the buyer, the seller may claim for damages.

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

Reverse break fees in North Macedonia might come in the form of a contractual penalty. If the buyer fails to pay the price and withdraw from the deal, the seller will be entitled to claim the agreed penalty for breaking the deal if such is agreed within the SPA. The same types of fees are applicable to the sell-side in case the seller leaves 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?

The initial public offering (IPO) exit is only applicable in cases of joint-stock companies (JSCs). However, other forms of companies may undergo a transformation process and become a JSC. The applicable laws allow for a limited liability company to be transformed in a JSC through an IPO.

The IPOs are regulated with the Law on Securities. Issuance, offers and sales of publicly traded securities are done after a prior approval of the Securities and Exchange Commission, in accordance with the Law on Securities.

The IPO is deemed successful if 60% of the stocks offered by the prospectus are registered to a holder's name and paid for within the relevant offering term, which cannot be longer than 12 months.

It should be noted that, in the entire history of the Republic of North Macedonia, there have been barely any IPOs and most securities transfers are conducted with private offers.

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

Due to the lack of such transactions, used lock-ups cannot be provided for North Macedonia.

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

Based on our knowledge and taking into consideration the local situation (please see question 7.2), there is no implemented dual-track exit process.

### 7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?

Technically, it is possible for a merger to happen between a shareholder (legal entity) and a special purpose acquisition company (SPAC), which by virtue of law can mean the possible dissolution of the seller, while the SPAC will continue to exist, with all the assets of the seller now acquired, including the relevant shares it previously held. However, taking into consideration of the development of the stock exchange market and the number of stock companies (*circa* 100), it cannot be stated that there is extensive practice of this type of transaction in North Macedonia .

## 8 Financing

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

Both private debt financing and third-party financing can be seen in different financing constructs, as well as a combination of both.

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

Under Macedonian law, a JSC is not allowed to finance the purchase of its own shares. Such limitation does not extend further to other forms of legal entities.

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

The financing market in our jurisdiction remains conservative and no recent trends in the debt-financing market in North Macedonia have been noted.

## 9 Tax Matters

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

The key taxation consideration is the 10% corporate tax rate imposed on locally incorporated or locally active companies. There is also a profit repatriation withholding tax of 10% that is payable unless there is a double taxation agreement between the jurisdictions, which stipulates something else.

The state offers tax breaks for greenfield investors, which invest in the so-called technological development zones. The typical tax break is a complete exemption to tax for a period of maximum of 10 years, as part of a state aid scheme in accordance with relevant local laws.

Off-shore structures/companies are present in North Macedonia; however, the obligation to determine and identify the beneficial owner of such off-shore jurisdiction companies under the local AML regulations (Law on prevention of money laundering and financing of terrorism) can considerably affect the conduct of the transaction, if there are no right actions undertaken in due course.

### 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)?

Share plans or similar models have become more common in practice in recent years, although they are not specifically regulated by Macedonian laws. As there are a significant number of subsidiaries of foreign companies, it is not uncommon for management to be granted shares or provided with some other form of a package directly by the parent company or another subsidiary further up the ownership chain. However, still capital gains tax obligations could be triggered.

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

There are no significant tax considerations for management when it comes to selling or transferring shares, save for the 15% personal income tax (PIT) (capital gains tax).

As an exception to the above, in cases of capital gains from the sale of securities and shares issued by investment funds, a tax rate of 15% applies if the equity was held in the seller's ownership for up to one year, while a tax rate of 10% applies if it was owned for a period between one and 10 years (full exemption if owned for more than 10 years).

In accordance with the Law on PIT, a general exemption exists when it comes to capital gains tax, i.e. capital gains tax is not subject to payment on the capital gains that resulted through the realisation of an IPO.

### 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?

During the COVID-19 pandemic, the Government provided several different forms of aid, including PIT tax relief to employers, although this measure had terms of application. As the initial measures were implemented quickly as a result of the increasing difficulties caused by the pandemic, depending on how the general economic situation will develop, the return of similar measures cannot be ruled out.

## 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?

Potential changes to the Law on Trade Companies were published in May 2022, which are envisioned to provide for the possibility of the majority shareholder, holding at least 95% of the issued share capital, forcing a squeeze-out procedure, which to date has only been possible in public takeover procedures, subject to the satisfaction of certain thresholds. However, the proposed amendments, as they currently are provided, also envision the possibility for the minority shareholder (holding the remaining >5% of the shares) to request for their shares to be bought by the majority shareholder.

If enforced, it can be expected that majority shareholders will utilise this provision, squeeze out the remaining shareholders, and proceed as a single shareholder company, which might represent a more attractive target to investors.

There are no other significant changes or developments that can affect the general M&A market.

Another novelty from 2021 worth mentioning was the anticipated establishment of the registry of ultimate beneficial owners, in accordance with the local AML law, which, after three years, made it possible for companies to register their beneficial owner in the registry. Local AML regulations were further updated, with the adoption of the new AML law in June 2022, as part of the process of harmonisation with the EU's 5th AML Directive.

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

Merger control can be triggered if the transaction and the parties involved meet the certain thresholds for mandatory merger fillings, as defined by Macedonian Law on Protection of Competition. Furthermore, if the company is involved in performing activities in a specific sector (e.g., insurance, management of investment funds, military equipment production, etc.), for which specific pre-approval is required in order for a change in the ownership structure to occur (directly or indirectly, as the case might be), the competent authority may need to grant such approval.

### 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.)?

There is no strict approach adopted locally. However, there is a general trend of red-flag due diligence for small-scale transactions (two to three weeks), and excessive, full-scale due diligence for larger transactions (one to two months). Save for the traditional areas of review (corporate, assets and property, managerial and general employment matters, specific regulatory aspects depending on the company's activity, IP, data protection) for small-scale transactions, narrowing the scope of analysis to few specific review areas is more common at present.

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

Anti-bribery and anti-corruption legislation and practice for legal entities are not a major issue for PE or other investors in North Macedonia.

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

The liability of PE investors is generally determined by the form of the portfolio company. As it can be concluded that there are no forms of companies used in practice other than limited liability companies and JSCs, in both legal forms the PE investors are not liable for the liabilities of the underlying portfolio companies. The Law on Trade Companies provides that a PE shareholder may be held liable for the obligations of the company if they:

(1) misuse the company as a legal entity to achieve goals prohibited for themselves as individuals;
(2) misuse the company as a legal entity to cause damage to its creditors;
(3) contrary to the law, dispose of the company's property as it is their own property; or
(4) reduce the assets of the company for their own benefit or for the benefit of any other person, and know (or should know) that the company is unable to fulfil its obligations towards third parties.

Of course, the liability might be invoked as a result of a contractual arrangement; for example, between the PE investor and a third, secured party (guarantee, pledge, etc.); however, the likeliness of such occurrence is low, taking all circumstances in consideration.

## 11 Other Useful Facts

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

There were no significant changes in recent period that could adversely affect PE investors and their decision to invest in North Macedonia. Favourable terms for investment, especially in free economic zones, still remain a great motive for foreign investors.

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Debarliev, Dameski & Kelesoska, Attorneys at Law (DDK) is the first law firm established in the Republic of Macedonia, distinguishing itself in the market with a clear business and corporate law orientation and complemented by an excellent network of legal experts covering the complete territory of the Republic of North Macedonia.
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DDK offers excellent legal services to clients involved in the biggest M&A and capital market projects in Macedonia, and has been engaged as counsel in numerous successful PPP and infrastructure projects, privatisations, real estate transactions, project financing, etc.

DDK's quality work and services are well recognised by the clients and, based on their opinions and evaluations, DDK has been ranked for many years in tier 1 law firms in North Macedonia by global law firm researchers such as *IFLR100*, *The Legal 500* and *Chambers and Partners*.

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# Norway

Aabø-Evensen & Co

Ole Kristian Aabø-Evensen

## 1 Overview

**1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?**

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 2021, LBO transactions of private targets dominated the transaction volume, representing 37.3% of the total PE transactional volume for that year.

In 2021, the total Norwegian M&A market experienced an increase in volume compared with 2020 and so did the Norwegian PE market, with a 103.6% increase in reported volume compared with 2020. For deals involving PE Sponsors in 2021, (either on the buy- or sell-side) the average reported deal sizes also increased significantly from €130 in 2020, to €334 in 2021. The market continued to be driven by new investments and add-ons but, in 2021, we witnessed a significant drop in the number of secondary investments, while the number of new investments as well as the number of exits increased significantly.

As mentioned above, the Norwegian PE market spans the width of all transaction types found in any mature market, but the typical *club deals* have, save for a few exceptions, for all practical purposes been outside the realm of the Norwegian PE market. The main reason for this is that most Norwegian transactions are of a size that normally does not require a major international PE fund to spread its equity risk in order to avoid exceeding investment concentration limits in its fund. The foregoing notwithstanding, sell-downs or syndication of minority equity portions subsequent to buyouts also occur in the Norwegian market.

By the number of PE transactions, TMT, services and the industrial and manufacturing sectors dominated the Norwegian market in 2021, each with 38%, 18% and 14% of the buyout investment volume, respectively. They were followed by the consumer sector with 6.6%, the construction sector with 6%, and the medial and the transportation sector, each with 3.6% of the total deal count, respectively.

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

The most significant features encouraging PE actors to transact in Norway are access to relatively inexpensive capital as well as a highly educated workforce, innovative technology, natural resources and a well-established legal framework for M&A transactions. In respect of the latter (see further in section 3), those familiar with M&A transactions and methodology in most other parts of Europe will find the Norwegian landscape quite familiar, both in respect of private and public acquisitions. Most EU regulations pertaining to M&A transactions have also been implemented in Norwegian law through membership in the European Free Trade Association ("**EFTA**") and the European Economic Area ("**EEA**").

Historically, an important factor, viewed by many investors as sheltering Norway against international financial turmoil, has been a high oil price. 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 may 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 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

In total, the 2021 reported M&A deal value for Norway increased from €25.265 billion for FY2020 to €41.247 billion for FY2021, while the average reported deal size increased from €308 million for FY2020 to €320 million for FY2021. What is particularly interesting is that some of the M&A activity witnessed throughout 2021 was, in itself, a result of the devastating effect of the pandemic for some businesses.

At the start of Q1 2022, the appetite for cross-border transactions continued when most of the restrictions from the COVID-19 pandemic were lifted. At the same time, we continue to see strong momentum for new PE deals in sectors such as healthcare, pharmaceuticals, and the industrial and manufacturing sector, which had all been less influenced by the pandemic. The same also applies for the TMT sector, even if some funds seem more cautious due to the drop in stock prices that many software companies faced on global stock markets at the start of 2022. So far, the most long-term effect of the pandemic is clearly that most PE funds have managed the transition into a new workday of completely digital deal-making. This trend of completing M&A deals via online collaboration software, and thus reducing the need for physical meetings when buying and selling businesses, is likely to continue. For the moment, we are, however, entering unchartered territory, due to the geopolitical turmoil following Russia's invasion into Ukraine. The conflict has placed many European countries into an energy crisis, with increased inflation and interest rates, as well as collapsing stock-prices, which together with the pandemic lag could become a bad combination, with long-term effects on consumer behaviour as well as business models, which are not yet clear to everyone. Still, we believe the PE sector is well placed to ride out the storm, due to its ability to quickly respond to changing trends.

Due to the COVID-19 pandemic, throughout 2020, as well as in 2021, the government implemented a set of temporary emergency legislation, relief programmes and other initiatives that may affect M&A deals entered into while the pandemic is ongoing, including a Temporary Competition Act setting out exemptions from certain procedural rules in the Competition Act because of the pandemic, such as extended deadlines for the government to intervene in merger control cases. This Act remained in force until the end of October 2020, but may potentially be reinstated, depending on the situation. The Companies Act and several other acts were also amended to allow online annual meetings. Some of these amendments are still in force, but may potentially be prolonged or repealed, in case new variants of the virus continue to emerge.

In addition, the government introduced a scheme under which it may provide state aid to companies fulfilling certain criteria and that have experienced losses in revenues owing to the pandemic. None of these programmes have been deterrent to PE funds activity into the Norwegian market yet.

Irrespective of which position one may take in relation to the long-term effects of the pandemic, the author believes many investors will continue to view Norway as a good place to invest, due to its highly educated workforce, technology, natural resources and well-established legal framework for M&A transactions. Consequently, our view is that the long-term effects of COVID-19 on PE in Norway will most likely be limited.

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

During the last decade, we have seen a number of family offices, but also smaller investment-firms, and individual investors executing PE style transactions in the Norwegian market. The main difference between the deal terms offered in such transactions is that some of these investors tend to be slightly more flexible with regard to their sweet spot for investing, the approach they take with regard to lock-up until exit, vesting structures, accepting investments in minority stakes, and the amount of leverage applied in the deal. Some of these investors tend to seek out investment opportunities in areas that have not typically been a focus for traditional PE funds, but where consolidation opportunities still exist. Examples of such investors are, *inter alia*, Ferd, Credo Partners, Icon and Hawk.

## 2 Structuring Matters

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

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 five 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 10.1); rules on thin capitalisation and deductibility of interests; withholding tax ("**WHT**") on shareholder debt and distributions; VAT; and corporate liability and disclosure issues, etc.

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

The equity structure in any PE transaction usually provides an opportunity and/or a requirement for the target's management to co-invest ("**Investing Management**") together with the PE fund in the acquiring group. The co-investment typically takes place at the Norwegian TopCo-level, or at the foreign holding company level. The equity strip for the Investing Management depends on the size of the transaction, but it is normally relatively small with a share price at an affordable level.

If the Investing Management mainly consists of Norwegian citizens, these may prefer to structure their co-investment into the Norwegian TopCo instead of into the foreign holding company structure. However, the PE fund may insist that the Investing Management must invest in the foreign holding structure. From a valuation perspective, it is imperative for both the PE fund and the Investing Management that the Investing Management's equity participation is acquired at "full and fair market value", as participation under Norwegian law otherwise may be subject to income tax (rather than tax on capital gains). In order to achieve that the Investing Management invests at the same price per shares as the Institutional Investors, the Sponsor will typically invest in a combination of shareholder loans, preferred shares and ordinary shares, while the Investing Management mainly invests in ordinary shares (i.e. shares with no preferential rights). The Investing Management's senior members may occasionally also be allowed to invest in the same instruments (or "institutional strip") as the Sponsor. The detailed structuring of the management incentive package will depend on the tax treatment of any benefit. If the Investing Management pays less than the market value of the shares this could, under Norwegian law, give rise to an employment tax charge (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 9.4.

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

In such situations, a PE investor will focus on the exact same issues as mentioned in question 2.2 (particularly if they are using leverage to acquire their minority stake) 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 nationals who reside in an EEA state or in the UK. With respect to this, at least half of the ordinary directors must fulfil the residential requirement; it will not suffice that solely deputy directors fulfil it, irrespective of how many of them are Norwegian residents or EEA nationals. The Norwegian Ministry of Trade and Industry may grant exemptions on a case-by-case basis. It should also be noted that, for public LLCs (irrespective of such companies being listed or not), Norwegian law dictates that each gender shall be represented on the board by (as a main rule) at least 40%. Consequently, on a board of five directors, there cannot be fewer than two members of each gender. Exceptions apply to directors elected by and among the employees (if any).

PE funds must also take into consideration the requirements for employee representatives on Norwegian boards. According to law, employees are entitled to board representation, both in private and in public LLCs, provided the number of full-time employees in such a company exceeds 30. Under such circumstances, the employees are entitled to elect between one and up to ⅓ of the board members from among the employees. The exact number of employee board representatives varies with the number of employees in the company, but all employee representatives have the same voting rights as regular board members. Employee board representation is not mandatory under Norwegian law, but cannot be rejected if requested by the employees and the conditions for such representation are fulfilled.

**Risks and potential liabilities for the directors appointed**

Like other directors, a Sponsor-appointed director of a portfolio company owes fiduciary duties to the company that takes precedence over duties owed to the shareholders appointing him. Directors owe their duties to *all* the shareholders, not only the individual shareholder or group of shareholders nominating him/her. Upon assuming office, the nominated directors will be subject the same potential personal director liability as any other member. Under Norwegian law, directors or executive officers may become liable for damages suffered by the company, shareholders or third parties caused by negligence or wilful acts or omissions. In addition, directors can be held criminally liable as a result of intentional or negligent contravention of the Companies Acts and/or ancillary regulations. As a general principle, all directors (including employee-elected directors) are subject to the same standard of care or fault standard and, although the board acts collectively, a director's liability is personal. Joint and several liability only applies to such actions or omissions attributable to more than one board member.

Examples of potential risks and liabilities that Sponsor-appointed directors should be particularly aware of relate to the board's heightened scrutiny in controlling that all related-party transactions (if any) between a portfolio company, its shareholders and/or its directors are concluded at arm's-length basis. In a PE investment, such transactions may typically relate to fixing the interest rates on shareholder loans, and/or intra-group loans between the acquiring companies and the target group, or payment of various forms of management fees, etc. between such parties. Other forms of transactions falling within the same category may be transactions that directly or indirectly aim at distributing funds out of a portfolio company to the Sponsors or to third parties. Also, directors should be particularly aware of the rule prohibiting a target company from providing upstream financial assistance in connection with the acquisition of shares in the target company (or its parent company). This prohibition against financial assistance has previously prevented Norwegian target companies from participating as co-borrower or guarantor of any acquisition financing facilities. Although, on 1 January 2020, Norway implemented a set of rules that further eases the previous strict ban of financial assistance (by amending the existing "whitewash" procedure), this is still an area that needs careful consideration and compliance with strict formalities if the respective directors shall stay out of peril (see further in section 8). On a general note, in order to be valid, related-party transactions must be approved by the board, and if the consideration from the company represents a real value exceeding 2.5% of its balance sheet amount for previous fiscal year, the board must prepare a special report to be distributed to all shareholders with a known address. In addition, such report must be filed with the Norwegian Registry of Business Enterprises. Certain exemptions from these requirements apply; typically agreements entered into as part of the company's normal business at market price and other terms that are customary for such agreements (see question 11.1). If the relevant company's shares are listed on a regulated market, additional requirements apply and such agreements must also then be approved by the relevant company's shareholders' meeting in order to be valid.

Directors violating any of the formal requirements described above may, at worst, expose him/herself to personal responsibility/liability for ensuring that any funds/assets distributed in violation of such rules are returned to the company. Note that the anti-asset stripping rules implemented by the AIFMD Act (see question 10.2) are also likely to result in personal liability for directors – in particular those appointed by the Sponsor if they contribute to the Sponsor's breaching of such anti-asset stripping provisions.

Further, note that, in the event that a portfolio company is in financial distress, its directors will at some stage come under obligation to cease trading and file for court composition proceedings or to liquidate the company. Such distress situations very often involve some type of prior attempts of restructuring or reorganising the business to salvage the various stakeholders' financial interests. These types of attempts could involve selling off assets or parts of the business to a stakeholder against such stakeholder being willing to contribute additional cash or converting debt into equity, etc. It is not uncommon that such transactions, in the event that these attempts later fail, may be challenged by other creditors, the receiver or trustee on behalf of the creditors, and they therefore entail substantial risks of liability for the various directors.

**Risks and potential liabilities for the Sponsors**

In terms of liability, the general point is that a Sponsor itself will not assume or be exposed to any additional liability simply by virtue of nominating/appointing directors to a portfolio company. However, a parent company or a controlling shareholder may be held independently liable for its subsidiary's liability if it has contributed to a wrongful act through a controlling interest in the company. Consequently, if the Sponsor has reserved so many vetoes over the portfolio company that the management team is no longer able to carry out its day-to-day business in the ordinary course without first consulting the Sponsor, this could, at least theoretically, mean that the Sponsor might be considered a "shadow director" or manager of the business. Under these circumstances, consequent liability issues can arise for the Sponsor if something goes wrong. That said, 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 so far come to a halt due to plummeting 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 immediately notify the company and the OSE (which is authorised to receive such notifications on behalf of the Financial Supervisory Authority of Norway ("**Norwegian FSA**")). Breaches of the disclosure rules are fined, and such fines have grown larger over the years.

Except for the insider dealing rules, disclosure rules, and mandatory bid rules (see below) there are generally few restrictions governing stake-building. However, confidentiality agreements entered into between a potential bidder and the target can impose standstill obligations on a bidder, preventing acquisition of target shares outside the bidding process. Subject to such limitations, the fund can also attempt to enter into agreements with key shareholders to seek support for a possible upcoming bid. Such agreements can take various forms, from an SPA, a conditional purchase agreement, some form of letter of intent, MoU, etc., or a form of pre-acceptance of a potential bid. Pre-acceptances are typically drafted as either a "soft" or "hard" irrevocable ("**Irrevocable**") – the former normally only commits the shareholder who gives the Irrevocable to accept the offer if no higher competing bid is made, whereas the latter commits the shareholder to accept the offer regardless of whether a subsequent higher competing bid is put forward. It is assumed in Norwegian legal theory, that a properly drafted "soft" Irrevocable will not trigger the disclosure requirements. 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 11.1). 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 2021. 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 2021, 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 2021, we estimate that close to 25% of all M&A deals in Norway used this type of insurance.

The W&I insurance product has become particularly popular among PE funds seeking a clean exit. Such funds have now started to arrange "stapled" buy-side W&I insurance to be made available to selected bidders in structured sales processes. Such insurances have also been used as a tool for the PE fund in order to get rid of the escrow clause in the SPA. Typical carve-outs/exclusions under such policies will comprise: pension underfunding; projections; transfer pricing issues; anti-bribery; secondary tax obligations; and uninsurable civil fines or penalties. For more on excess/policy limits, see question 6.5. The cost of such insurance depends on the industry in which the target operates, the type of insurance coverage requested, the target itself and the parties involved, but will typically be in the range from around 0.8% to 1.8% of the insured amount.

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

Save in respect of vendor liability for locked-box leakage or breach of specific restrictive covenants, which are normally subject to special liability regulations (please see question 6.3), a PE vendor will normally attempt to include several limitations on its potential liability for breach of the SPA and its obligations, covenants, warranties and indemnities thereunder. Significant variations will apply depending on the market conditions, the parties' bargaining position, the target's industry sector and individual circumstances.

Historically, if a PE fund was on the sell-side, it would very often start with proposing a six to 12-month limitation period for the general warranties, and a period of between 12 and 24 months for the tax warranties. However, the introduction of the W&I insurance product has led some of the Norwegian funds to become slightly more generous with the length of the limitation periods offered in their first draft of the SPA. The main reason is that the insurance market is able to offer a 24-month limitation period for the general warranties, and between five and seven years on tax warranties at a very little price difference compared to shorter limitation periods.

A PE vendor will typically (but depending on the market conditions) also start off with proposing a relatively high "*de minimis*" (single loss) threshold combined with a basket amount in the upper range of what traditionally has been considered "market" in Norway for such limitation provisions. PE funds exiting their investments today may also attempt to align the basket amount with the policy "excess amount" under W&I insurance. This typically means an amount from 0.5% to 1% of the target's enterprise value, depending on the insurance market and which insurance provider is underwriting the policy. The standard policy excess amounts offered by the insurance industry is normally 1% of enterprise value, which is above the historical level of what has been considered market value for the basket amounts in Norway, but currently an increasing number of insurers are willing to offer 0.5% of the enterprise value as the policy excess amount. While the majority of the deals in the Norwegian market 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 entering 2022, this trend has now come to a halt, with declining stock market prices.

### 7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?

Potential mergers with special purpose acquisition companies ("**SPACs**"), so-called blank-check companies, whose only objective is to raise capital in an IPO in order to acquire one or more private companies through a merger (commonly referred to as a de-SPAC transaction), have, until now, not been a popular alternative route to an IPO exit in the Norwegian market. Until 31 March 2022, only three de-SPAC deals involving Norway target companies have been observed during the period following 1 January 2019 – none of which involved a Norwegian acquiror – and none of the SPAC IPO listings were carried out in Norway. So far, the most notable de-SPAC deal involving a Norway target company has been Alussa Energy Acquisition Corp.'s acquisition of Freyr AS, a Norway-based developer of clean, next-generation battery cell production capacity, for a total consideration of €344.8 million. Upon completion in 2021, Freyr was listed on NYSE and renamed as Freyr Battery.

Typically, the ideal scenario of a SPAC is to domicile within the same jurisdiction as the target company, as a cross-border merger may trigger several tax implications. It is the SPAC sponsor that will have to decide on the jurisdiction of incorporation, and at that time the sponsor does not necessarily know the target's jurisdiction. The SPAC will therefore incorporate in the jurisdiction that they expect to identify a target, or alternatively in a foreign jurisdiction with tax neutrality and no withholding taxes, capital gains taxes, or stamp duties levied.

From a Norwegian perspective, the main market and legal challenge when considering a de-SPAC transaction is that there remains no harmonised regulatory approach to SPAC transactions across the EU or Europe, because structures and approach will depend on what is permitted under national law. The Norwegian FSA has not yet approved listings of SPACs in Norway and as such there is no special prospectus or disclosure requirements specific to the listing of SPACs. According to the Norwegian FSA and OSE, there is an ongoing process reviewing potential new rules regarding the listing of SPACs, but they are awaiting further guidelines from the European Securities and Markets Authority before deciding on the issue. Consequently, any prospectus regarding listing of a SPAC in the Norway market, will presently have to be drafted and reviewed in accordance with the regular EU prospectus rules and requirements, where the prospectus and listing application would likely be rejected.

For the moment, it is also unclear if SPACs will be characterised as alternative investment funds ("**AIFs**") under Norwegian law. The Norwegian FSA has not provided any guidance on this. In our view, where a SPAC pool capital is raised by investors, a pooled return could only be generated at the point of a de-SPAC and, consequently, the SPAC should not be deemed an AIF. Even so, it is still slightly uncertain as to whether the AIF assessment shall be based on the characteristics of the SPAC at the time of the IPO in isolation, or if such assessment must take into consideration the SPAC's characteristics at the time of the de-SPAC. Irrespective of this, in our view a typical SPAC should, in most cases, be deemed a holding company exempted from the AIF rules. When considering a de-SPAC transaction, a PE sponsor will also take into consideration that such types of transaction very often include earnouts as part of the merger consideration to the target shareholders, which are typically tied to share price milestones or specific business objectives. It is also worth noting that it is fairly uncommon for de-SPAC transaction earnouts to be in the form of cash.

## 8 Financing

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

Norwegian LBOs generally involve bank debts as the main source for financing in the form of term loans and a revolving credit facility. In large transactions, the senior loan will be governed either by Norwegian or English law, with one bank acting as an agent for a lending syndicate. In such syndicated transactions, the senior loan agreements used are normally influenced by the forms used internationally, in particular the standard forms developed by the Loan Market Association. A typical leveraged PE structure may, depending on the size of the target, contain several layers of debt. Historically, it was quite common to use a combination of senior facilities and mezzanine facilities, whereby security is granted to a security agent. In certain circumstances, the mezzanine debt was also issued in combination with warrants to purchase equity in the target. However, due to the severe hit mezzanine investors faced during and after the credit crunch, it became difficult to obtain such financing at reasonable prices, and many Sponsors started to consider mezzanine financing too expensive. Over the last eight years, mezzanine financing has rarely been seen in the Norwegian market for new transactions. One of the more important reasons for this change has been the development of a very buoyant Norwegian high-yield bond market, which largely substituted the traditional mezzanine facilities. Such transactions would typically involve "bridge-financing commitments" pursuant to which either a bank or a mezzanine provider agrees to provide "bridge" loans in the event that the bond debt cannot be sold prior to completion. Due to a rapid decline in oil prices during 2014 and 2015, the Norwegian high-yield bond market took a severe hit from October 2014 and onwards throughout most of 2016. Since the 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. Entering 2022, the Norwegian bond market is now turbulent, with interest rates and credit spreads rising sharply. Market activity is significantly declining, with the total debt issue volume in the Nordic high-yield market for the first half of 2022 reaching NOK 44 billion, compared with NOK 113 billion for the same period in 2021.

### 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 Tax Matters

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

Key tax considerations relating to Norwegian PE acquisitions typically include: (i) quantification of the tax costs associated with the acquisition; (ii) management of tax charges of the target group; (iii) exit planning (including a partial exit); and (iv) tax-efficient compensation to the management of the target group. Sponsors operating in the Norwegian market quite commonly use offshore structures for achieving a tax-efficient acquisition structure.

**Costs of acquisition**

No stamp duties, share transfer taxes or other governmental fees apply in connection with a share sale under Norwegian law. The tax treatment of transaction costs depends on whether these are classified as costs for acquisitions/disposals, operating costs, or debt-financing costs.

As a general principle, all transaction costs incurred directly in connection with an acquisition of shares should be capitalised for both accounting and tax purposes with the acquired shares. The costs will be added to the tax base of the shares and may therefore reduce any capital gain arising upon a subsequent disposal to the extent the disposal is not covered by the Norwegian participation exemption rules. Note that, according to the Norwegian participation exemption rule, Norwegian shareholders that are limited companies, as well as certain similar entities (corporate shareholders), are generally exempt from tax on dividends received from, and capital gains on the realisation of, shares in domestic or foreign companies domiciled in EEA Member States including the EU, Norway, Iceland and Liechtenstein. Losses related to such realisations are not tax-deductible. Since normally both the target and BidCo used by the PE fund will be LLCs domiciled in Norway, the acquisition costs in connection with a share deal will not effectively be deductible under the current Norwegian tax regime.

Notwithstanding the above, certain expenses incurred by a company in connection with the ownership of shares/subsidiaries (i.e. costs for corporate management and administration, strategy work and planning, marketing costs, financing costs, restructuring costs, etc.) should be deductible on a current basis for corporate tax purposes under Norwegian law. Broken-deal expenses that are incurred in connection with failed acquisitions of shares (typical expenses relating to due diligence) are not deductible for tax purposes.

In principle, costs of arranging the financing (i.e. fees in connection with obtaining and maintaining debt, bank charges and associated advisory/legal fees) should be deductible on a current basis. It is important to distinguish between financing costs, which are considered interest for tax purposes, and other financing costs, as interest costs are subject to the Norwegian interest-deduction limitation regime (see below). 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. Providing 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 should not apply in the year it becomes part of the acquiring fund group and the target group. Interest cost disallowed under the limitation rules can be carried forward for 10 years, but subsequent deduction is also dependent on capacity for interest deduction, *inter alia*, within 25% of taxable EBITDA.

The "group rule" applies if the deducted net interest expenses exceed NOK 25 million in total for all companies domiciled in Norway within the same group. Where the threshold amount is exceeded, deductions are limited to 25% of taxable EBITDA on a separate company basis. It may thus be beneficial for a group to partly refrain from deduction of interest expenses to avoid exceeding the threshold.

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 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.

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

The most common tax-efficient arrangement considered by management teams in PE portfolio companies is to structure the managements' equity participation via private holding companies to benefit from the Norwegian participation exemption rule. This would allow for a tax-exempted rollover at a later sale or deferred taxation of the capital gain until management distribute the capital gains from their holding companies. Under Norwegian law, arrangements such as growth shares and deferred/vesting arrangements may entail a risk that parts of any capital gains will be subject to employment income tax and social security unless it can be documented that the shares were acquired or subscribed 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 35.2% 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.

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

The key tax considerations for the Investing Management selling and/or rolling over part of their investment into a new acquisition structure, include:

- Rollover relief:
  - For individual shareholders, as a starting point no statutory rollover relief exists that allow shares to be exchanged for shares without crystallisation of a capital tax charge.
  - If the Investing Management has invested through a separate holding company or pooling vehicle, the Norwegian participation exemption rule will allow rolling over part of such investment into a new acquisition structure without triggering capital tax charges.
  - Subject to certain conditions being fulfilled, a rollover relief could be achieved in cross-border transactions also for individual shareholders.
- Exchanging shares for loan notes:
  - For individual shareholders, this will not qualify for rollover relief, and will attach a tax charge.
  - If the selling management team's investment is structured through separate holding companies or a pooling vehicle, exchanging shares for loan notes will, under the Norwegian participation exemption rule as a starting point, not trigger any tax charges.

Other key issues that need to be considered are: to what extent will any members of the team be subject to tax if the target or the PE fund makes a loan to members of the team to facilitate the purchase of equity? Will tax and social security contributions be due if such loans are written off or waived by the lender? Loans from a Norwegian company to any of its direct or indirect shareholders being private individuals holding more than 5% of the shares in the company (or to such shareholders' related parties) will be taxed as dividends on the part of such individual shareholder (see question 9.4). Nevertheless, the taxed amount will increase the shareholder's individual paid-in capital position and can be distributed as a dividend subsequently without taxation. The Investing Management must also consider if any restrictions to the transferability and other terms at which new shares/financial instruments will be acquired may affect the income tax treatment of such instruments. Links that are too close to the employment can lead to the re-characterisation of the income/gains from such instruments. For more issues, please see questions 2.3 and 9.1.

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

There are no explicit Norwegian tax regulations regarding distribution of carried interest to Managers in exchange for their services. Only when there is a strong connection between Norwegian resident active owners' personal labour contribution and the Carry, can the Carry be taxed as salary. 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. Nevertheless, depending on what capital the carried interest is based on, if the risk for losses is greater than the limited partners' and the allocation of the Carry, the Carry may still be defined as capital income. Further, reallocation of carried interest between the general partners and the Manager based on general transfer pricing principles is also an issue that the tax authorities follow up where there are different tax consequences.

Introduction of the principal purpose test ("**PPT**") and simplified limitation of benefits ("**LOB**") in the tax treaties with respect to dividend WHT may have impact on some structures; however, under the prevailing structure in Norway (which is the Luxembourg holding structure with certain substance in Luxembourg), the WHT exemption would still generally rely on the EEA exemption for corporate shareholders that are not established as wholly artificial arrangements for the purpose of avoiding tax. 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.

## 10 Legal and Regulatory Matters

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

The Alternative Investment Fund Managers Directive ("**AIFMD**") was implemented in Norwegian law on 1 July 2014 (the "**Act**"), and applies to Managers of all collective investment vehicles (irrespective of legal structure, albeit not UCITS funds) that call capital from a number of investors pursuant to a defined investment strategy (alternative investment funds ("**AIF**")).

There are two levels of adherence under the Act. The first is a general obligation to register the AIF Manager with the Norwegian FSA and provide the agency with information, on a regular basis, regarding: the fund's investment strategy; the main category of instruments it invests in; and the largest engagements and concentrations under its management. Failure to comply with these reporting requirements may induce the Norwegian FSA to demand immediate rectification or impose a temporary ban on the Manager's and the fund's activities. The foregoing applies to all AIFs, whereas the second level of adherence (see below) only applies to funds that have either (a) a leveraged investment capacity exceeding €100 million, or (b) an unleveraged investment capacity exceeding €500 million, and where its investors do not have redemption rights for the first five years of investment. Where an AIF exceeds these thresholds, the Manager must, in addition to the reporting requirements above, obtain authorisation from the Norwegian FSA to manage and market the fund's portfolio, herewith conducting its own risk assessments, etc.

From a transactional point of view, and particularly with respect to 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.

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

Norway has, as in many other countries, tightened its grip on national security reviews of foreign direct investments, by implementing a new National Security Act, granting the government powers to intervene and stop acquisitions of shares in a company holding investments in sectors considered vital from a Norwegian national security perspective. It is therefore expected that PE investors' investments within such sectors or particular transactions within such sectors in the near future could become subject to enhanced scrutiny by the Norwegian government, even if this so far has not been very prevalent in the Norwegian market.

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

In a structured process, PE investors tend to limit diligence scope and timeframe (i.e. only key issues/areas of interest) and only request a very limited and preliminary "red-flag" legal due diligence report on the target. This is simply an economic (cash-saving) approach, allowing the fund to show interest and get to know the target more intimately without "burning cash" on what may turn out to be an uninteresting or too costly object. If the fund is invited into the final bid round of an "auction" process, and provided only few bidders remain in contest, the diligence field is opened up, and PE funds normally ask its advisors to prepare a more complete diligence report on legal, financial, commercial and compliance matters. Further, on compliance diligence, see question 10.4. The level of scope, materiality, etc. will depend on certain associated factors, like whether the fund has obtained exclusivity, whether the target is reputable or otherwise familiar to the investors, the equity, debt and liability history of the target, the prevailing M&A market (to some extent, the warranty catalogue reflects the diligence process), and so forth.

PE funds normally always engage outside expertise to conduct diligence in connection with LBO transactions. This will normally also be a requirement from the senior banks in order to finance such transactions. Even if the fund has in-house counsel, outside expertise is engaged so that the fund's investment committee can make informed decisions on the basis of impartial, qualified and independent advice.

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

In our experience, particular Pan-European and global funds have, in the last few years, increased their focus on and concerns about regulatory and compliance risk in their diligence exercises. For some of these funds, it has become standard to request legal advisors to prepare separate anti-bribery reports to supplement the regular diligence report, often also accompanied by a separate environmental, social and governance ("**ESG**") report. Some of the funds also require that the sellers provide separate anti-corruption and anti-bribery warranties in the SPA.

Previously, Norwegian funds were more relaxed and it was not market practice to request such special reports. Now, this seems to slowly change, and on the diligence side we see a continuing focus on legal compliance 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).

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

The general rule under Norwegian law is corporate personhood, whereby a portfolio company alone is held accountable/liable for its own acts and omissions – i.e. a Norwegian court of competent jurisdiction will only pierce the corporate veil in exceptional circumstances.

From this general point of basis flows certain limited, but important exceptions, namely that a parent company or a controlling shareholder may be held independently liable for its subsidiary's liability if it has contributed to a wrongful act through a controlling interest in the company (see question 3.6). For practical purposes, such liability can be divided into "criminal liabilities" and "civil liabilities".

The criminal liabilities category includes anything that a portfolio company may do or refrain from doing, which carries the potential risk of criminal prosecution. In respect of publicly listed companies, and thus relevant in relation to IPO exits or *public-to-private* transactions, such "criminal liability" may arise in connection with *market manipulation* (undertaken in order to artificially inflate or deflate the trading price of listed shares), *insider dealing* or *violation of relevant security trading regulations* (e.g. wilful misrepresentation or omission of certain information in offer documents). If a portfolio company violates such regulations, and its PE investor (either on its own, through the violating portfolio company or through another portfolio company) transacts in securities affected thereby, there is a tangible risk that the PE investor will be identified with its portfolio company (i.e. the shareholder *should have known*), and thus held liable for the same transgression(s).

In the category of "civil liability" (meaning that liability usually is limited to fines or private lawsuits), the same consolidation (identification) rules may come to play if a portfolio company violates, e.g. applicable antitrust or environmental legislation. Over recent years, we have seen very few, but disturbing, examples of decisions by Norwegian courts in which it was ruled that environmental liability of a subsidiary (unable to remedy the situation on its own) was moved upwards in the holding structure until rectification was satisfied.

The foregoing notwithstanding, the general concept of corporate personhood and individual (contained) liability is still the all-encompassing rule of practice, and we have yet to see any case where a PE investor or another portfolio company has been held liable for its portfolio company acts or omissions in Norway.

## 11 Other Useful Facts

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

**Tax treatment of capital gains from foreign funds to Norwegian investors**

PE funds would normally be AIFs not subject to the beneficial tax rules applicable for Securities Funds. However, in a 2019 ruling by the Supreme Court, a fund was considered a Securities Fund, whereby also capital gains on investments in shares outside the EEA are tax exempted. Whether or not capital gains from investments in AIFs are subject to participation exemption for Norwegian corporate investors, depends on whether the fund is considered transparent or non-transparent for tax purposes and the location of transparent fund's portfolio companies. The classification of a fund in its country of residence does not mean that the fund must be classified equally for Norwegian tax purposes. For instance, a foreign non-transparent fund could be deemed transparent for Norwegian purposes if one or more investors have unlimited liability for the fund's obligations and a foreign transparent fund could be deemed non-transparent if the general partner does not have a real economic interest in the fund, e.g. by right to a carry or at least 0.1% of the ownership of the fund. A transparent fund would as a starting point be comprised by participation exemption independent of its country of residence. If the fund only invests in portfolio companies resident within the EEA, there are generally no tax issues for Norwegian corporate investors. However, negative tax consequences for Norwegian investors would occur if the funds invest in portfolio companies in low tax jurisdictions in the EEA or generally outside the EEA. If over 10% of the funds' equity investments are not comprised by the Norwegian participation exemption method in a two-year period, realisation on interest in the fund itself would not be comprised by tax exemption hence 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 participation exemption, provided the underlying investment is covered by participation exemption.

The participation exemption would also apply for an investment by the fund in a company in a non-low tax jurisdiction outside the EEA, provided the funds hold at least 10% of the shares and voting power for more than two years. However, if the investment is made through a holding structure, e.g. a US portfolio company owned via CI, the structure could have negative tax consequences as capital gains from the portfolio investment would be taxable even if the funds qualify for participation exemption. In a non-transparent fund, the residency of the portfolio company would be 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. Further, even if the fund should be classified in a specific way for Norwegian tax purposes, one should also consider whether CFC regulations or specific hybrid consideration could apply, changing the taxation for Norwegian investors. A sale of shares in a transparent fund to a foreign investor could trigger exit taxation for the Norwegian seller on latent capital gains on portfolio companies not qualifying for 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 will mainly have an impact on investors domiciled in Norway investing into PE funds organised as limited partnerships, since the profit and losses from such limited partnerships under Norwegian law must be allocated among its partners and will be taxed at the hand of such partners.

**VAT**

On 16 May 2013, the Norwegian tax authorities issued a much criticised memo in which the authorities argued that in the event a Sponsor provides advisory and consultancy services to its portfolio companies, such services should be subject to 25% VAT. This raises difficult classification issues between the Sponsor's ordinary management of its portfolio companies, which, in general, is VAT-exempt, and other consultancy/advisory services that may be subject to VAT. The authorities have indicated that individual circumstances in a tax inspection may determine that parts of the management services provided by a Sponsor must be reclassified as consultancy services and therefore will become subject to VAT under Norwegian law. There has also been an increased aggressiveness from the authorities on this area and we expect that this will continue in the coming year.

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. A recent white paper has proposed that all import of services should be subject to Norwegian VAT, whether or not the buyer carries out business or not.

**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.

In addition, amendments to the MiFIR and MiFID II are being proposed for implementation into Norwegian law.

**Amendments to the disclosure requirements under the STA**

As of 1 September 2022, certain amendments to the STA with regard to disclosure requirements for derivatives with shares as underlying instruments will be implemented. According to the new rules, the materiality thresholds and disclosure requirements that apply for acquisition of shares in listed companies shall 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. As from the same date, borrowing and lending of shares shall become subject to the same notification regime for both the lender and the borrower. Soft irrevocable undertakings will remain exempt from the disclosure obligations. The disclosure obligations under the STA have, until now, also included an obligation to disclose information in relation to "rights to shares", regardless of whether such shares have already been issued or not. This is a stricter disclosure and filing obligation than those set out in minimum requirements of the Transparency Directive and, from 1 September 2022, this obligation will be abolished. As from the same date, Norwegian law will no longer have mandatory disclosure obligations for warrants and convertible bonds not linked to any issued (existing) shares.

**Changes to the OSE's issuer rules, etc.**

Throughout 2020 and as of 1 March 2021, the OSE has also implemented a set of changes to the issuer rules on the OSE, Euronext Expand, and Euronext Growth Oslo. It should be noted in this respect that the OSE has updated its relevant rule books for the various exchanges (formerly "continuing obligations of stock exchange-listed companies"). In contrast to the former situation, where the OSE had its own rule books for various financial instruments and its own rules for admission and current liabilities, respectively, all these sets of rules have now been collected in Rule Book II.

**New takeover rules expected**

In addition, a committee is currently also working on a report concerning the Norwegian rules governing voluntary and mandatory offers, with a particular focus on the STA current limited regulation of the pre-offer phase. This committee report does not arise out of changes to EU rules but rather the need to review and update Norwegian takeover rules on the basis of past experience and market developments. On 23 January 2019, the committee submitted a report concerning the Norwegian rules on voluntary and mandatory offers, with a particular focus on the current limited regulation of the pre-offer phase.

It is unclear when the 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 2023.

**Ole Kristian Aabø-Evensen** is one of the founding partners of Aabø-Evensen & Co, a Norwegian boutique M&A law firm. Ole assists industrial investors, financial advisors and PE funds, as well as other corporations in friendly and hostile takeovers, public and private M&A, corporate finance and other corporate matters. He has extensive practice from all relevant aspects of transactions, both nationally and internationally, and is widely used as a legal and strategic advisor in connection with the follow-up of his clients' investments.

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# Saudi Arabia


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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 Saudi M&A and private equity sector continued to soar in 2021. Private equity transactions by size hit a new record in 2021. Buyouts and strategic mergers and acquisitions continued to dominate the space. Nearly 50% of the Middle East private equity transactions took place in The Kingdom of Saudi Arabia (the "Kingdom" or "Saudi"), with a total value of USD 27.3 billion. The number of deals increased by 40% compared to 2020.

Venture capital ("VC") transactions in Saudi witnessed a record high, increasing in value by 270% and in number of transactions by 54% when compared with 2020 (Manitt SVC Report 2021).

On the smaller scale of private equity, the Kingdom also witnessed the effective launch of a number of angel investment syndicates, which target to invest in start-ups and early-stage companies with high growth prospects.

In 2021, the Saudi Public Investment Fund released its new strategy in investment, VRP2 (the second Vision Realization Program, or "VRP"), which is based on growing new sectors in the Kingdom. The new strategy will roll out USD 40 billion of new investments every year until the end of 2025 (https://ussaudi.org/saudi-arabias-public-investment-fund-new-strategies-investments-and-diversification).

As expected in 2020, private equity transactions' focus moved to chemicals, pharmaceuticals, renewables, medical equipment, and logistics in 2021, as these sectors witness consolidations in light of global economic trends. Saudi Aramco closed a USD 12.4 billion infrastructure deal with a global investor consortium including EIG and Mubadala, in which the consortium acquired a 49% stake in Aramco Oil Pipelines Company, a subsidiary of Aramco (https://www.aramco.com/en/news-media/news/2021/aramco-closes-infrastructure-deal-with-global-investor-consortium). By the end of 2021, Saudi Aramco announced another USD 15.5 billion gas pipeline deal with a global consortium led by BlackRock Real Assets and Hassana Investment Company, making it one of the world's largest energy infrastructure deals and Aramco's second major pipeline transaction of 2021 (https://www.aramco.com/en/news-media/news/2021/aramco-announces-landmark-gas-pipeline-deal).

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

The regulatory framework in the Kingdom is constantly being developed for the purpose of accommodating local and foreign investors. The Ministry of Investment ("MISA"), which is the authority responsible for overseeing regulatory procedures relating to foreign investments, introduced new flexible and more relaxed regulations that removed previous restrictions. MISA announced that in 2021, 112 transactions valued at SAR 50 billion were (indirectly) licensed by MISA, and that it granted 575 new foreign investor licences in H2 of 2021 (https://www.argaam.com/en/article/articledetail/id/1529022). These transactions witnessed the entry of new investors in the Kingdom across 12 sectors. According to the Saudi Central Bank ("SAMA"), foreign investment in Saudi Arabia grew by 18% to SAR 2.4216 trillion in 2021 (https://www.argaam.com/en/article/articledetail/id/1550853).

The real estate sector also witnessed growth in 2021 due to changes in regulations, whereby foreign investors were permitted to own properties in Makkah and AlMadinah. MISA's introduction of an instant licensing regime had a positive impact and increased real estate deals in the Kingdom.

Additionally, the Capital Market Authority ("CMA"), which is the body responsible for governing and licensing investment funds, has issued a number of notable amendments in its efforts to attract more investors. These regulatory developments included: (i) the removal of foreign ownership restrictions on unitholders in a CMA regulated fund; (ii) issuance of relaxed requirements in relation to obtaining Authorised Persons licences, which relaxed the requirements to obtain fund management licences; and (iii) decreasing the minimum capital requirement for fund management licences. This has resulted in the creation of an attractive ecosystem for local and foreign investors.

### 1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

Despite the impact of COVID-19, Saudi witnessed a surge in private equity deal value as noted above.

With respect to government intervention, the Saudi government continued its efforts to mitigate the negative impact of COVID-19 on its economy. The governments' efforts active in 2021 can be summarised as follows:

(i) the creation of an economic vehicle worth SAR 50 billion from banks and financial institutions dedicated to support SMEs;
(ii) the Public Investment Fund ("PIF") established a new investment vehicle with the purpose of investing in VCs and private equity firms dedicated to investing in SMEs;
(iii) the Ministry of Human Resources and Social Development allocated SAR 17 billion for the purpose of aiding entities facing economic constrains and guaranteeing job stability; and
(iv) the VRP2 strategy of PIF and the investments resulting from it.

The above measures reflected a decrease in the unemployment rates amongst Saudis by 11% and a rise in GDP by 3.2% in 2021 (https://www.argaam.com/en/article/articledetail/id/1547854 and https://www.argaam.com/en/article/articledetail/id/1543642).

The pandemic had the effect of shifting investment funds' focus to benefit from the accelerated digitisation of the Saudi economy, including the hyper growth of e-commerce and related fields. The digitisation effects on the economy, and the central role private equity funds will play in it, are likely to become permanent fixtures as consumers are unlikely to revert to less convenient modes of transacting, and the economy witnessed the ability of private equity to accelerate growth in a manner that directly yields consumer benefits.

Additionally, the pandemic depressed certain company valuations, especially in negatively impacted sectors, such as construction and building materials. This has triggered strategic acquisitions beyond what was previously seen in the market.

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

Strategic acquisitions are the most common form of private equity transactions in the Kingdom, and they customarily involve privately held businesses as buyers and sellers. In such transactions, private companies enter into joint ventures. As such, in addition to traditional private equity firms, private companies play a huge role in the private equity ecosystem in the Kingdom.

## 2 Structuring Matters

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

The most common forms of business acquisitions in the Kingdom are acquisition of shares in a target company or acquisition of the underlying business assets of a target company. The choice of form differs based on a number of factors, notably due diligence results. Nevertheless, the acquisition of shares is more common in Saudi than the latter.

Furthermore, the main legal forms commonly involved in acquisitions in Saudi are limited liability companies ("LLCs") and joint-stock companies ("JSCs"). Both forms are governed by the Companies Law issued by Royal Decree No, M/3 dated 28/01.1437H corresponding to 11/11/2015G.

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

As mentioned in question 2.1, acquisition of shares is common in the Kingdom due to its cost-effectiveness and efficiency. In such structure, the acquiring company will not be burdened by the need to transfer employees, obtain further licences, and enter into new sale contracts (where applicable). Additionally, in a share purchase, the acquiring company also inherits the target company's liabilities. As a result, a share purchase transaction demands a more involved and detailed due diligence. As such, while share acquisition saves both time and costs, it results in transferring the liabilities of the target company to the acquiring company. Asset acquisitions may be executed through either purchasing all the assets of the target company or through choosing certain assets.

The Saudi General Authority for Competition ("GAC") plays an important role in approving acquisition transactions based on certain criteria mentioned in our answer to question 4.1.

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

Because strategic acquisitions form a significant part of private equity transactions, the equity in the transactions is mostly structured in a very simple manner: ordinary shares owned by all shareholders, including management or through employee ownership programmes. This is furthered by: (1) the legal regulatory restrictions placed in respect of preferred stock, where the Companies Law prescribes to a large degree the rights attributable to preferred stock, which exclude voting rights; and (2) the fact that the dominant corporate form in Saudi is the LLC, and LLCs are limited by law to issue ordinary shares.

That said, it is common for transactions involving funds to be structured via foreign holding companies that own the Saudi-based target company. Such structuring permits more flexibility in the equity structure, and the common equity structure where this is applied is for the investors to own voting preferred shares while management own ordinary shares.

Fund managers commonly receive carried interest of 20% of fund returns, mostly following European waterfall. The carried interest in a Saudi fund is paid as a fee, and not as distribution on a class of units.

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

Investments into LLCs and JSCs, where the investor is taking a minority interest, customarily involve the grant of minority protections to the investor, including veto rights in respect of certain reserved matters, both at board and shareholder level, tag-along rights and, in certain scenarios, a liquidation preference. It is also customary for investors, including minority investors, to require management lock-ups and minority drag rights. These rights are customarily detailed in shareholders' agreements that are negotiated and entered between the parties.

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

With the exception of venture financing, management equity grants tend to range between 10% and 20%. Grants are customarily subject to vesting over four years and the company customarily retains a right to re-purchase the shares upon departure.

In venture financing, founders customarily own a majority of the shares through the initial financing rounds by investors. Founders customarily get diluted beyond owning a majority of the shares after the third round of financing.

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

Customarily, good leaver scenarios are limited to involuntarily leave, such as incapacity or death. Bad leaver designations are attributed to departures prior to a certain negotiated period, and departures for cause, including fraud and wilful misconduct. We do see circumstances where bad leaver designations are further elaborated to include failing to diligently attend to the company's business.

## 3 Governance Matters

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

In LLCs and JSCs, the governance structure entails establishing a board of directors that includes investor representatives, and the establishment of certain reserved matters that require the approval of the investor director(s). These reserved matters customarily include the approval of business plans, annual budgets, major corporate actions, management compensation, and debt ceilings.

Investors also customarily negotiate designating certain decisions to be reserved for the vote of the shareholders, with veto rights over such decisions to investors. This helps the investors address concerns relating to the fiduciary obligations placed on directors, and how the investors may vote in scenarios where their interests diverge from those of management.

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

As noted above, private equity investors customarily negotiate veto rights to their nominated directors over major corporate decisions. These reserved matters cover business plans, related party transactions, and disposal or acquisition of assets that exceed a certain assigned cap. We customarily see such rights granted even where the investors take minority positions, provided that the minority is meaningful (i.e. not less than 10%).

Additionally, private equity investors in LLCs may be granted veto rights by virtue of the Companies Law, which will be reflected in the target company's articles of association ("AoA"). Art. 174(1) of the Companies Law provides that the capital of the company may be increased subject to the affirmative vote of all shareholders. As such, where an investor rejects an increase in the capital, such rejection serves as a veto vote. Additionally, art. 174(2) further states that the AoA of an LLC may not be amended unless the affirmative vote of 75% of the shareholders has been obtained. As such, the Companies Law enforces certain restrictions that can operate as veto rights to investors who are shareholders in an LLC.

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

Veto arrangements must be in line with the Companies Law. Where a veto item overlaps with the Companies Law, the Companies Law prevails. As such, when drafting the shareholders' agreement, one needs to assess its validity in conjunction with the Companies Law of the Kingdom and the AoA of the target company, in order to avoid diluting veto rights otherwise preserved where applicable.

With respect to director veto rights, directors should remember that they are subject to legal fiduciary obligations in respect of their decision-making, including the exercise of veto rights, which oblige them, in general terms, to act for the benefit of the company. As such, the exercise of director veto rights should always be within the confines of director fiduciary obligations.

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

There are not typical duties owed by private equity investors to minority shareholders; however, when minority shareholders have more experience in the management of the company or in fact are the founders of the business, they are granted management roles by having board seats allowing them to continue the management of the company, including the appointment of nominating the C-level employees.

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

A shareholders' agreement is considered enforceable provided that no provision goes against Shariah principles or the Companies Law of the Kingdom.

With respect to the limitations imposed on the shareholders' agreement, while Saudi law generally recognises indemnities and liquidated damages, certain restrictions may be enforced where damages or indemnities are presented before a Saudi court. Where damages are payable, the quantum of damages is assessed on the basis of the loss actually suffered and Saudi law will almost never award punitive or consequential damages. As such, if liquidated damages are challenged, a Saudi court may not enforce the payment of all liquidated damages should they be found to be excessive. The Saudi court would assess the fairness and reasonableness of the liquidated damages prior to enforcing them. Similarly, indemnities are subject to the same fairness and reasonableness test should they be challenged before a Saudi court.

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

The liability of the directors nominated by private equity investors is identical to that of the other company directors. Pursuant to art. 165 of the Companies Law, directors are generally liable in instances where they act in bad faith, violate the AoA and Companies Law, or cause harm/damage to the company. Additionally, courts grant discretion to directors in respect of business decisions made in good faith, akin to a "business judgment rule"; however, decisions involving a conflict of interest customarily present a limit to such discretion, and courts can find directors liable to make the company whole of costly decisions made by conflicted directors.

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

Usually, the shareholders' agreement and the AoA regulate this issue by imposing an obligation on any director in the board pursuant to art. 71 of the Companies Law to notify the board of directors of any direct or indirect interest he/she may have. In the event such board member fails to disclose any conflict of interest, the shareholders have the right submit a petition to the judicial authority to invalidate any decisions made based on such conflict of interest obliging the concerned director to return any profit or benefit realised therefrom. Additionally, it is customary for shareholders to require that directors not be permitted to vote in respect of transactions where they are conflicted. This point should be considered in depth by private equity clients in light of their overall investment direction.

## 4 Transaction Terms: General

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

As a significant number of companies in the Kingdom are family-owned businesses, they tend to transfer from one generation to another. When the first generation of shareholders transfer their ownership to the second generation, feuds tend to occur. Said feuds hinder the process of acquiring and/or purchasing shares. As such, feuds amongst the shareholders are considered a major issue, impacting the timetable for completing transactions.

Following the point on family businesses, legal due-diligence request lists may result in delays in completing transactions due to the generational changes. While due diligence in itself does not hinder the execution of transactions, some private companies struggle to provide all the due-diligence items requested due to the constant change in management or ownership. As such, the target company takes time in providing all requested items to commence the due-diligence process and therefore impacting the timetable for transaction completion.

In addition to the above, term sheets are considered relatively new in the Saudi market. As such, more time is spent in negotiating them rather than jumping to drafting the necessary agreements to affect the transaction. Thus, in VC transactions, the negotiations related to the term sheets result in delaying the closing of transactions.

Lastly, the GAC, in its efforts to combat monopolistic behaviours and practices, requires entities to notify it where a transaction results in possessing a dominant position, therefore constituting economic concentration (which is defined to include companies with a revenue of SAR 100,000,000 (combined)) in the Saudi market. As such, where a private equity transaction is to trigger economic concentration, the notification to GAC and approval process may result in affecting the timetable for transactions completion. The GAC notification and/or approval process customarily takes three or four months.

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

The year 2021 saw an increase in transactions in the energy sector, with Saudi Aramco leading transactions worth more than USD 30+ billion. As the transaction values increased in the Kingdom, we witnessed an increase in transaction syndication amongst funds. A significant portion of transaction documents also carried clearly prescribed exit provisions that bind the company and its management to work towards listing company shares for public trading with a timeframe, customarily two to five years, or permit an exit for the investors.

## 5 Transaction Terms: Public Acquisitions

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

Applicable laws in the Kingdom do not stipulate challenges that may be faced by private equity investors in public-to-private transactions. Nevertheless, public company acquisition regulations do apply, and stipulate certain notice and tag requirements that must be adhered to by private buyers of publicly listed companies.

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

This is not applicable.

## 6 Transaction Terms: Private Acquisitions

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

In private equity transactions, the preferred consideration is cash, which is customarily paid following the satisfaction of certain conditions precedent pursuant to a share subscription or purchase agreement entered into by and between the buyer and the issuer/seller. In certain strategic acquisitions, the buyer can pay through share issuance to the sellers but, due to the complexity involving valuations, this form of consideration is not the most common. Other market trends such as share swapping are not very common in the Kingdom; however, in 2022, we are expecting to witness new trends in light of the capital market volatilities.

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

This usually depends on the business; for tech companies, intellectual property warranties are very important, along with warranties covering the company's finances. Additionally, warranties covering assets, contracts, and regulatory compliance are customarily given. Fundamental warranties are also always included, covering: (i) validity of legal existence; (ii) ability to enter into transactions/agreements; and (iii) no violation and compliance with applicable laws.

Buyers are customarily entitled to be warranty claims or be indemnified in respect of sellers' breaches of warranties, usually with the standard *de minimis* floors and caps.

Additionally, private equity directors should expect indemnities for directors and officers against losses arising from mistakes, unless such mistakes were caused by wilful misconduct, fraud, bad faith, or forgery, and towards losses arising from the directors' performance of their duties in conformance with all applicable laws.

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

Customarily, transaction documents include interim covenants restricting the conduct of business between signing and closing the acquisition transaction. Additionally, management or founders are subject to non-compete covenants and lock-up undertakings that restrict their ability to compete and/or sell.

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

While transactions tend to carry extensive representations and warranties, it is highly uncommon for parties to bind representations and warranties insurance in respect of acquisitions. We have come across such insurance policies in Saudi.

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

Customarily, sellers' liabilities are capped at the consideration paid by the buyers. That said, *de minimis* floors and, at times, liability buckets, are agreed between the parties.

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

While escrowed security is not common in private equity transactions in Saudi, earn-out clauses that permit price adjustments following closing based on escrowed amounts are. Liability for warranty breaches is customarily covered through direct claims, which can be capped to the investment or purchase amount in certain transactions.

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

The Kingdom issued the Commercial Pledge Law and the Law on Securing Rights with Movable Assets issued by Royal Decree No. M/94 dated 15/8/1441H corresponding to 28 April 2020G. Said laws have provided security with respect to sourcing financing, since such issue has been neglected prior to the issuance of both laws. As such, it is anticipated that the enactment of the laws aforementioned will boost acquisition financing in the Kingdom. At this time, acquisition financing is highly uncommon.

The courts in the Kingdom can be reluctant to mandate specific performance for violation of contractual obligations, such as the obligation to close on the purchase of shares or assets, favouring awarding monetary damages *in lieu* of forcing parties to complete an agreed transaction.

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

While break fees are customary to protect the buyers, which incur costs in relation to the purchase, reverse break fees, whereby the buyers would pay the sellers should they fail to consummate a transaction, are not typically agreed in Saudi. That said, where it was clear that the sellers will incur significant transaction costs, they may wish to negotiate such provision.

## 7 Transaction Terms: IPOs

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

Customarily, initial public offering ("IPO") preparation is a time-consuming exercise that can take upwards of one year. Private equity sellers looking at IPOs for an exit should consider conducting an IPO readiness analysis on the target to assess the time it will take to prepare the target for an IPO.

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

Pursuant to art. 69 of the Rules on the Offer of Securities and Continuing Obligations issued by the Board of the CMA, private equity sellers are customarily locked up from selling their shares upon an IPO for a period of six months. That said, sellers may wish to apply to the Capital Market Authority for an exception, which may be granted on a limited basis. Additionally, private equity sellers should also be aware that the Companies Law prescribes that founding shareholders (determined at the time the company is incorporated or converted into a joint-stock company) cannot sell their stock for a period of two years from incorporation or conversion. This can function as a natural lock-up period, and is important to consider to correctly time the conversion or incorporation of the listing vehicle.

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

The Saudi public equity market remains small, and while an IPO is a viable exit path, it is not the main exit path. Acquisitions remain the main exit path for private equity sellers. As such, it is customary for sellers to pursue a dual-track exit process to increase the likelihood of an exit.

**7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?**

Currently, de-SPAC transactions are not common in the Kingdom and we usually see IPOs exits instead; this is due to the listing requirements that they are not in line with the pace of an entity established for a de-SPAC transaction. Common challenges for de-SPAC transactions in the Kingdom are mostly the listing requirements, such as the submission of three years of audited financial accounts for Tadāwul, with market capital of SAR 300 million; other stock exchanges such as Nomu require the submission of only one year of operational and financial performance, with market capital of SAR 10 million. Due to the high demands of listing on Tadāwul, the stock exchange is currently considering allowing de-SPAC transactions.

## 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).**

Acquisition financing has recently been introduced in Saudi. Nevertheless, it is anticipated that the Commercial Pledge Law and the Law on Securing Rights with Movable Assets issued in 2020 can potentially offer further governance with respect to securing financing for private equity transactions.

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

This is not applicable.

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

This is not applicable.

## 9 Tax Matters

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

Saudi companies are subject to a two-tier tax structure, whereby companies pay income tax of 20% in respect of the portion of income equal to the foreign-owned shares in the company, and pay Zakat of 2.5% of the enterprise value in respect of the Saudi-owned shares in the company. In addition, foreign shareholders are subject to a 20% capital gains tax in respect of share sales, and a dividend withholding tax of 5%. The use of offshore structures is common in private equity transactions in Saudi, and it is recommended that investors consult tax advisors to determine the most appropriate ownership structure for the target company to render an effective tax footprint.

Companies operating in the oil and gas sector are subject to a higher bracket of income tax.

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

As individual income is not subject to tax, management-driven tax structures are not considered.

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

The key tax matter to be considered in the event of disposal of shares or the restructuring thereof is the capital gains arising out of the transaction. Sellers are encouraged to consult tax advisors to consider whether an efficient transaction structure may be identified to reduce their tax footprint, including the sale of Saudi assets through dispositions of holding offshore vehicles.

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

This is not applicable.

## 10 Legal and Regulatory Matters

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

As mentioned under section 1 above, the CMA and MISA have been developing their relevant laws related to investment funds and foreign ownership in the Kingdom, creating an attractive private equity ecosystem for both local and foreign investors.

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

This is not applicable.

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

Legal due diligence is a huge factor in private equity deals that could either affect a transaction or put an end to it. The timeframe associated with the due diligence drastically varies depending on the nature of the transaction and the form of acquisition, but two to five weeks is a reasonable timeframe for an LDD exercise.

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

There has been no visible impact.

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

Private equity investors should gain an understanding of the rules surrounding piercing the corporate veil, mostly prescribed pursuant to the Saudi Companies Law. Thin capitalisation and a lack of appropriate accounting can serve as grounds for the shareholders to be held liable for company debts.

## 11 Other Useful Facts

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

Factors that could affect private equity investors in the Kingdom tend to revolve around Saudi's applicable law, which includes Shariah principles. The applicability of Shariah principles affords Saudi courts a wide discretion in determining outcomes of claims. As such, many transactions in Saudi elect the laws of England and Wales or the Dubai International Financial Centre ("DIFC") to govern documents and/or subject disputes to arbitration.

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HAMMAD & AL-MEHDAR
LAW FIRM

# 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.

The volume of private equity deals rebounded strongly in 2021 with over 100 deals worth more than US$12 billion in 2021. Exit value was also high at over US$7 billion, compared to just US$1.3 billion in 2020.

Headline making deals include Grab Holdings' US$40 billion stock-for-stock merger with Altimeter Growth Corporation and its subsequent initial public offering (IPO) on NASDAQ, a GIC-led consortium's US$3.6 billion investment in Flipkart Group and ESR's US$5.2 billion acquisition of ARA Asset Management.

**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. In 2021, the Singapore Exchange introduced rules allowing for the listing of special purpose acquisition companies on the Mainboard of Singapore Exchange Securities Trading Limited, providing investors with more choice and opportunities.

These developments make Singapore an attractive gateway to investing in the region.

**1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

COVID-19 has had varying effects across different industries in the private equity market, muting growth in sectors like energy and utilities, travel and hospitality and aviation, and boosting growth in sectors such as fintech, e-commerce, technology, media and telecommunications and healthcare. As borders and travel restrictions ease further, and with employees returning to the office, there will likely be renewed interest in the consumer products, real estate, travel and hospitality and aviation sectors.

Private equity firms continue to focus on investment in sectors that are expected to experience high growth, including digital healthcare, e-commerce, e-learning, technology, media and telecommunications, digital payments, financial services, fintech and digital assets. Valuations are expected to remain high owing to record dry powder at the disposal of private equity firms, creating a steady demand for investment opportunities, while a limited number of high-quality companies, political uncertainty and geopolitical tensions serve to reduce the pool of attractive targets.

Distressed M&A activity has not been prominent as the Singapore government committed close to S$200 billion from 2020 to 2022 to support Singaporeans and businesses. These measures include: a job support scheme, providing support for workers' wages; a Temporary Bridging Loan Programme, providing cash-flow support for enterprises; and the COVID-19 (Temporary Measures) Act, providing temporary relief to businesses that are unable to fulfil their contractual obligations under certain contracts due to the pandemic.

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

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 400 registered in Singapore in 2020 and more than 100 applications approved by the Monetary Authority of Singapore in the first four months of 2022. The approach taken by each family office differs, but 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, and they tend to have a longer investment horizon and may not prioritise exits, especially if wealth preservation is the main goal.

## 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 and war, and governments' and central banks' reactions to such outbreaks.

## 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. This 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.

### 7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?

Yes, we have seen some interest with seeking potential mergers with special purpose acquisition company (SPAC) entities as an alternative to an IPO exit.

The key advantage of a de-SPAC transaction over an IPO is that the pricing in a traditional IPO (through an extensive book-building exercise) will depend on market conditions at listing after extensive work, time and cost have been invested, while for de-SPAC, the price of the sale is negotiated with the SPAC upfront. Another attraction in listing through merging with SPAC is that this could allow the incoming business access to the operational expertise of the SPAC sponsor, bearing in mind that the profile, track record, and reputation of SPAC sponsors and their management team is one key factor for assessing the suitability of the SPAC and, as such, SPAC sponsors are often experienced financial and industry professionals who have a broad network of contacts for business owners to tap on, whether for investment or management purposes.

The disadvantages of de-SPAC compared to an IPO exit are that the de-SPAC involves multiple transactions: (i) an M&A; (ii) convening of a shareholders' meeting for the de-SPAC (which may be administratively more difficult given the SPAC would be listed with public shareholders); (iii) a comprehensive due diligence and regulatory review process identical to an IPO; and (iv) as there could be a capital shortfall from potential redemptions as initial SPAC investors may redeem their shares (regardless of whether they vote for or against the de-SPAC), the SPAC may be compelled to undertake additional private placement financing to make up the shortfall.

Further, the U.S. SPAC/de-SPAC market is facing headwinds and regulatory scrutiny, which has increased the expense, uncertainty and risk in pursuing de-SPAC transactions in the U.S. While the Singapore de-SPAC framework was always intended to involve a comprehensive due diligence and regulatory review process identical to that of an IPO, it remains to be seen how the nascent Singapore SPAC market will pan out and whether there will be any adverse impact from the developments in the U.S. SPAC market.

## 8 Financing

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

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 Tax Matters

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

Any income accruing in or derived from Singapore (i.e., sourced in Singapore) or accruing or derived from outside Singapore (i.e., sourced outside Singapore) that is received or deemed received in Singapore, is subject to income tax in Singapore. There is no capital gains tax in Singapore.

Foreign-sourced income in the form of dividends, branch profits and service income received or deemed to be received in Singapore by a Singapore 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.

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.

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

There are no 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 no capital gains tax in Singapore, one of the key considerations for private equity transactions is whether the gains from such transactions constitute capital gains or trading income, the latter of which is subject to Singapore income tax. For example, the gains from a sale of shares may be regarded as trading income and subject to income tax if the entity disposing the shares is regarded by the 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) immediately prior to the date of the disposal, the divesting company has held at least 20% of the ordinary shares in the investee company for a continuous period of at least 24 months; and (b) the shares disposed of are ordinary shares, and not preference, redeemable or convertible shares. This rule does not apply to: (i) a divesting company whose gains or profits from the disposal of shares are included as part of its income as an insurer; (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 (but not 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; or (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.

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

As mentioned 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.

### 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?

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, 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.

## 10 Legal and Regulatory Matters

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

**Amendments to 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.

**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 (c) 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.

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

Private equity investors are not subject to enhanced regulatory scrutiny. Generally, only transactions involving regulated industries will be subject to enhanced regulatory approvals – these include, *inter alia*, acquisitions exceeding the prescribed percentage in Singapore incorporated banks, capital markets services licensees, licensed insurers and telecommunications providers. Public-to-private transactions will also need to comply with the regulatory regime under the Singapore Code on Takeovers and Mergers.

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

Private equity investors typically engage outside counsel to conduct legal due diligence on the target prior to any acquisition. Timeframes for conducting legal due diligence vary, and usually take between one to three months. Such legal due diligence is usually conducted on an "exceptions only" basis, and the materiality and scope will depend on the private equity investor's internal compliance and financing requirements, the complexity of the target's business, and the timeframe for the particular acquisition.

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

Compliance with applicable anti-bribery and anti-corruption laws is a prerequisite to most, if not all private equity transactions in Singapore. If non-compliance is a concern, private equity investors will usually seek to restructure the transaction to isolate the risk (e.g., by acquiring assets instead of shares).

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

Singapore courts would generally not pierce the corporate veil and/or hold a private equity investor liable for the liabilities of underlying portfolio companies or hold one portfolio company liable for the liabilities of another portfolio company in the absence of fraud or bad faith.

## 11 Other Useful Facts

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

Singapore is an investor-friendly jurisdiction and is consistently ranked as one of the easiest countries in which to do business. Most laws and regulations are in line with international best practices and should be familiar to experienced private equity investors.

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# Spain



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## 1 Overview

### 1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?

According to the Spanish Venture Capital & Private Equity Association ("Asociación Española de Capital, Crecimiento e Inversión", "ASCRI"), the Spanish Private Equity ("PE") industry has shown its resilience, in spite of the uncertainty at all levels that marked year 2021, overcoming the scenario marked by the pandemic. PE in Spain in 2021 reached its second-best figure on record in terms of investment volume, with a growth of 21% compared to 2020 and breaking its record in terms of the number of investments and the number of companies funded (678), 90% of which were SMEs and growth stages. Nine hundred-and-thirty-three investments were executed (an increase of 11% with respect to 2020). Companies received EUR 7.573 billion in equity (second best figure on record), which represents an increase of 21% with respect to 2020. Middle-market transactions (between EUR 10 million and EUR 100 million) also marked a new record high for the third year in a row in terms of the number of transactions (94), making it their second-best year in terms of investment volume (EUR 2.437 billion). Recovery in large transactions (over EUR 100 million per transaction) in which the international funds have played a leading role, together with an exceptional investment level in start-ups in mature stages, partially explains such positive investment performance. International management companies continue to be major market players accounting for 80% of the total investment volume (EUR 6.098 billion), the second-best figure on record following 2019, with 236 transactions (a record high for the ninth year in a row). However, Spanish investors, mainly family offices, have also played an important role, with an increase of 5% in the number of investments (554), although its investment volume decreased 8% from 2020 (EUR 1.3506 billion). The public sector also played a relevant role, particularly through its support in the fundraising stage.

On the divestment side, 361 transactions were closed (compared to 302 in 2020), representing EUR 26.679 billion in divestment (64% increase *vs* 2020, returning to the 2019 level).

The most active sectors in terms of PE investment in 2021 were IT (32%), followed by energy and natural resources (25.7%) and, in distant positions, healthcare (8.7%), leisure (7%) and consumer goods (6%).

The year 2021 was also extraordinary for fundraising in Spain, showing a 38.7% increase *vs* 2020 (EUR 2.961 billion), being the second-best year on record. Support of the public sector through various funds of funds programmes (such as Fond-ICO Global, the European Investment Fund and Innvierte by CDTI) should also be noted in this respect.

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

Increased visibility of economic recovery in 2021, partly driven by the success of the vaccination campaign, the available liquidity and low interest rates lead to a strong reactivation of investments through 2021. Unfortunately, 2021 optimism has been 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 will most likely affect the PE market, that 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 2022.

Likewise, following an extraordinary year in 2021, 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 2022: (i) the costs in the investee portfolio have increased significantly in 2021 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 time 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 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?

One of the long-term effects relates to valuations. It is very likely that, except for a few very specific sectors, valuations (i.e.

EBITDA multipliers) may drop. Another effect may relate to greater competition for fewer or smaller transactions, which may lead to an inflation in pricing.

From a legal point of view, the restrictions and control over essential freedoms, such as the freedom of movement of capitals and the limitations on foreign investments imposed by the Spanish government as described in question 1.2 above, are still in place, with the consequences described above.

However, certain government interventions had – and some still have – a positive impact on investments. Regulations such as: (i) the issuance by the Spanish Official Credit Institute ("ICO") of a debt and bond programme (bank guarantee lines) for Spanish entities; (ii) the implementation of furlough schemes ("ERTEs"); and (iii) the application of tax flexibility measures, have provided, and still provide in some cases, oxygen to Spanish SMEs and some large corporates.

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

Without representing a consistent trend, a few family offices or structures managing the capital of third parties as well as other funds, which in the past focused more on mezzanine financing or opportunistic transactions, are now engaging more in traditional PE.

In addition, some large industrial companies are investing in companies that develop new technologies linked to their core business. Some differences between those kinds of transactions and traditional PE deals are: (i) more flexibility in the exit horizon; (ii) the investment is sometimes driven by the access to the information and/or technology, instead of pure financial return; and (iii) more difficulties in terms of corporate governance, remuneration/ratchets of the management team and willingness to retain access to the developed technology after exit.

## 2 Structuring Matters

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

The most common structures are: (i) acquisition of companies in which a part of the purchase price is financed 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's structure is more commonly used to canalise the acquisition financing, partly in order to avoid financial assistance and to benefit – when financing is needed – and pledge over the target group's shares and assets, which are granted to the financing entity.

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*") in order to invest in most Latin American targets, 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 (provided that valid economic reasons and sufficient substance following OECD's BEPS regulations are met).

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

The main drivers for PE transactions essentially relate to: (i) financial considerations and the ability to grant sufficient warranties to the financial entities; and (ii) tax reasons, not only looking for tax-efficiencies but also due to the requirements imposed by the country of origin or by Spanish tax regulations for tax deductibility.

Other drivers are: (a) the expected returns for the investor; (b) the role and incentives of the management team and PE sponsors; (c) the economic and operational costs related to the post-closing restructuring of the company; and (d) the rules and costs of exit.

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

As mentioned above, PE transactions can be executed directly in the target company or channelled through BidCos.

The 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 unless they entail control.

In Spain, PE funds usually acquire majority stakes, unless their investment policies require otherwise or they agree to hold non-controlling positions alone or in combination with other partners; either other strategic investors, PE sponsors, or founding families. In such cases, being granted additional rights (other than those that would correspond to its proportion of share capital owned) becomes a key negotiation for PE investors with non-controlling positions, such as veto rights and reinforced majorities in strategic decisions, seats at the board of directors or managing bodies, exit provisions (including tag-along rights, put options, etc.) and key management retention or exit schemes, amongst others. When the controlling shareholder is not another PE fund, the non-controlling PE investor usually requests some protections to facilitate a potential exit at a certain stage.

### 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.

On the contrary, the main reasons why management equity holders are treated as "bad leavers" may be: (i) disciplinary dismissal based on misbehaviour in the workplace; (ii) being found guilty by a court of a criminal offence jeopardising the company; (iii) voluntary resignation of the management equity holder (except if as 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 board of directors of their portfolio companies, even when their representation in the board is higher than in the share capital. They control the decision-making process and are involved with the company's business and day-to-day operations. However, in cases where the PE investor holds a minority stake or for any other reason is not allowed to appoint a director, PE investors usually reserve the right to appoint an observer, who can participate in the board meetings without voting rights.

PE investors can usually impose super-majority voting requirements for the passing of certain key decisions of the company, both in general shareholders' meetings and board of directors' meetings, as well as impose to the company and managers to provide information to shareholders that might not otherwise be entitled by law.

The composition of the board of directors 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.

### 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.

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

The Spanish Capital Companies Act ("LSC") sets forth some binding minimum and maximum majorities to decide on certain matters (such as the removal of directors, amendment of the company's by-laws or corporate restructurings, to name a few) or on some matters restricting the rights of certain shareholders with the express consent of the affected shareholder. These limitations can be modified or agreed differently between the parties in the shareholders' agreement but may not be included in the by-laws of the company or registered and, therefore, they become private agreements amongst the shareholders enforceable amongst them but not against any third parties.

Likewise, the requirement of the unanimous favourable vote for the adoption of certain matters at the board of directors' level can be included in the shareholders' agreement but not in the by-laws, as such provisions are rendered void and, therefore, not enforceable.

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

PE investors have no specific duties towards minority shareholders, unless voluntarily assumed by the PE investor. Nonetheless, pursuant to the LSC, resolutions of the company may be challenged when they are contrary to the Law, the by-laws or the company's meeting regulation, or damage the interest of the company to the benefit of one or more shareholders or third parties. 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)?

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.

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

A PE investor should be aware of the fiduciary duties it may have as director or as member of the board of directors, or those of its appointed directors. Directors may not be subject to any ground of prohibition or incompatibility to discharge their office and, in particular, to any of those established in the Law 3/2015, of March 30, 2015 and other related legislation or any statutory prohibition and, in particular, those established in the LSC.

Directors' duties are, among others, diligence, loyalty, avoiding conflict of interest situations and secrecy. Directors are held personally accountable for any damage caused by their acts performed without diligence or against the law or the company's by-laws. Directors are liable to the company, its shareholders and the creditors of the company for any damage they may cause through acts (or omissions) contrary to the law or the by-laws, or carried out in violation of the duties inherent to their office, provided that there has been intentional misconduct or negligence.

Additionally, it is also important to bear in mind that these duties of directors and the related liability resulting from a breach of these duties are also extended to those persons or entities acting as "shadow" directors or "*de facto*" directors. This is the main risk applicable to PE investors that nominate directors to boards of portfolio companies.

Most directors of PE-invested companies in Spain usually contract D&O insurance to cover their civil liability to a certain extent.

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

Directors must refrain from discussing and voting on resolutions or passing decisions in which the director or a related person may have a direct or indirect conflict of interest. Excluded from the foregoing prohibition are the resolutions or decisions that affect the director in its condition as such, such as the director's appointment or removal from positions on the administration body or others similar.

In any event, directors have the duty to adopt the necessary measures to avoid situations in which their personal interests, or those on behalf of others, can conflict with the company's interests and their duties to it. Therefore, directors must also refrain from, among others, engaging in activities on their own behalf or on behalf of others that involve effective competition (whether actual or potential) with the company or that in any other way place it in permanent conflict with the interests of the company.

## 4 Transaction Terms: General

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

PE transactions do not usually require prior authorisation, except for those undertaken in regulated sectors such as, but not limited to, gaming, financing, telecom, public concessions, energy, air transport, sports, media sectors and tour operators. Authorisations can be at the European Union, national or local levels depending on the applicable regulation.

In addition, as explained above, the new article 7-*bis* of Spanish Law 19/2003, of July 4, subjects FDI in strategic sectors (critical physical or virtual infrastructures, critical technology and dual-use items, essential commodities, in particular, energy, sectors with access to sensitive data and media), made by residents (or which beneficial owner is resident) of countries outside the European Union and the EFTA, to prior administrative authorisation by the Spanish Government (Council of Ministers) if, as a consequence of such investments, the investor holds a stake equal to or greater than 10% of the capital stock of the Spanish company or effectively participates in the management of the Spanish company or in its control.

As of March 18, 2020, FDI is also restricted (and may be subject to prior authorisation) to foreign investors that are directly or indirectly controlled by a third-country government (including public agencies, the military or armed forces), amongst others. This subjective condition may impact sovereign wealth and certain pension funds and other institutional investors who are natural investors in PE funds.

Finally, authorisations are also required for those acquisitions that result in a business concentration that exceeds certain antitrust thresholds (supervised by both Spanish and European Union competition authorities).

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

In recent years, auctions and initial public offerings ("IPOs") are gaining special prominence with respect to bilateral transactions. Recent trends include the increasing use of locked-box and earn-out structures *in lieu* of post-closing adjustments of the purchase price, 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 (i.e. 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 this 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.

## 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.

### 7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?

Indeed, there have been two deals with Spanish companies that have been merged with foreign special purpose acquisition companies ("SPACs") (Wallbox and Codere Online).

However, there are certain legal and tax challenges that have not helped to develop the incorporations of SPACs in Spain, including public tender offer rules, corporate law rules (which currently complicate the conditions of a potential merger) and tax rules (which have limited Spanish SPACs and de-SPAC transactions). A draft bill to amend certain articles of the Spanish Corporations Law and Spanish Securities Markets Law is currently being discussed, which, if approved, will certainly reduce such challenges.

## 8 Financing

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

The most common source of debt is bank financing. However, alternative financing tools have arisen, especially since the last global crisis where banks were not providing liquidity enough, such as in direct lending (vendor's loans or direct financing at the target company) and financing obtained from some mezzanine debt funds.

The combination of both banking financing and alternative financing has proved interesting since it allows for far more complex and flexible structures, with higher returns. This is typically applied in hybrid structures where debt funds not only provide equity but also debt.

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.

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

Financial assistance (that is, to advance funds, extend credits or loans, grant security, or provide financial assistance for the acquisition of its own quotas or shares) is the main legal restriction under the LSC.

Additionally, there are some tax limitations imposed to tax deductibility of interests (as further explained in section 9 below).

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

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) has slowed down debt-financing activity in recent months, with an apparent consensus to wait until September–October to follow up on these new developments and how they will actually impact the market.

## 9 Tax Matters

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

Unless the investor is resident in a tax haven, income obtained by non-resident investors in Spanish PE-regulated vehicles (both dividends and capital gains derived from the transfer of shares in the Spanish PE) is not usually subject to taxation in Spain.

Subject to the investor tax residency, interest income obtained by non-resident investors could be subject to Withholding Tax (except if the lender is the beneficial owner of the interest and they are a European Union resident). Other types of vehicles require careful 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.

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

It is common practice for the management team to receive incentive packages based on risk-sharing principles and the maximisation of value at exit. Considering tax-efficiency reasons, management teams usually focus their attention on: (i) sweet equity or ratchets; (ii) payments of deferred bonus (which may enjoy certain reductions for tax purposes if generated 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 26% 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).

Recently, amendments have been introduced in the relevant applicable regulations in the territories of the Basque Country and Navarra to clarify and provide certainty to managers in connection with the taxation of the carried interest. The goal of this amendment is to align and to clarify that, if certain conditions are met, carried interest will be taxed as a capital gain or income on movable property, rather than as employment income. This also follows a recent trend in other European Union jurisdictions.

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

As mentioned in question 9.2 above, capital gains at exit are generally subject to Personal Income Tax at a 26% marginal tax rate.

The main tax consideration in the reinvestment of part of the management team's investment into a new acquisition structure is that the exchange 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.

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

The last legal reform operated in the tax area with a significant impact in the PE industry and structures was carried out in 2014, with effects as of January 1, 2015 (mainly due to the amendments on interest deductibility – specific limits for LBO transactions – and tax consolidation). As explained in question 9.2 above, recently, the territories subject to Foral and special tax regimes (Basque Country and Navarra) have enacted certain regulations on carried interest. In 2020, a 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 analysis of the rationale and substance of structures as a whole (following OECD/BEPS approach). This has been reinforced with the implementation into Spanish regulations of the provisions of ATAD 2 Directive, covering all the types of hybrid situations and hybrid mismatches.

Tax rulings aimed at 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.

## 10 Legal and Regulatory Matters

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

No significant new legislation affecting PE investments was enacted or amended in 2021.

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

PE transactions are not subject to any prior authorisation unless, as stated in question 4.1 above, the company is engaged in a regulated sector, the transaction results in a concentration of companies that exceeds certain antitrust thresholds, or the transaction requires prior FDI authorisation.

Further, any foreign investments or divestments in Spanish companies (no matter who the final foreign investor is) must, however, be communicated to Spanish authorities once executed, for statistical purposes only.

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

Due diligence work is a process to be performed thoroughly, since the report usually covers an extensive analysis of the potential investment from several perspectives, including legal, financial and commercial, tax, technical, regulatory and compliance. However, red-flag reports, sample-based due diligence and materiality thresholds are common as well. The scope and detail of the analysis are also adjusted depending on the insurance requirements and limitations of coverage.

It is generally conducted by outside advisors specialised in each area. The usual timeframe covers between two to four weeks, depending on the information available, the commitment, the resources devoted by each party and the technology used in the process.

Publicly traded companies are normally exempt from due diligence work.

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

PE sellers are increasingly focusing on compliance and anti-corruption/anti-bribery regulations. PE companies are incorporating internal compliance officers primarily focused on undertaking extensive and carefully supervised AML due diligence every time the entity approaches a potential investment.

Further, compliance provisions are becoming increasingly common in investment agreements (particularly as a representation to be provided by the selling shareholders) and/or shareholders' agreements.

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

A PE investor may be held accountable for the liabilities of the underlying portfolio companies: (i) if the PE investor is considered a company "shadow director"; or (ii) if the court lifts the corporate veil of the portfolio company and, consequently, the action or omission for which a liability has risen is attributed to the PE investor.

Otherwise, a portfolio company (or its directors, officers or employees) cannot be held accountable for the liabilities of another portfolio company.

## 11 Other Useful Facts

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

Most of the relevant factors that a potential PE investor must consider when approaching a Spanish investment have already been addressed in the previous sections. As in any other economy, legal certainty, political stability, foreign exchange rates, labour and union regulations, and other rights become major considerations to investment in our jurisdiction.

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Our PE teams sit in the main offices of the Firm's extensive Spanish and international network, thereby finding the right blend between specialist expertise and local market knowledge.  The PE group works in close collaboration with other industry specialists, ensuring optimum quality and tailor-based analysis for each acquisition and for each investor.
Our PE practice covers areas such as setting-up funds, acting on behalf of management teams and investors, advising transactions in seed or venture stages, LBOs or MBOs and funds of funds transactions.
Our experience accumulated in the sector has made Garrigues one of the leading providers of tax and legal services to PE firms, LPs, GPs and other industry players.  Garrigues M&A and PE partners are highly and consistently recognised by the most prestigious rankings and international legal directories and by their clients.

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GARRIGUES

# Switzerland


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## 1 Overview

**1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?**

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. 2021 was a record deal-making year for private equity (according to the KPMG M&A Sector Reports for Switzerland in 2021).

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

Low interest rates for transaction financing, as well as favourable borrowing conditions, still generate an incentive for private equity activity. However, the records of 2021 will likely not be reached due to the uncertainty relating to the conflict in Ukraine.

**1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

As also experienced in 2021, the COVID-19 pandemic has not slowed private equity deal-making down in the long term. Companies receiving government funding due to the pandemic must comply with certain restrictions, e.g. they may not disburse dividends for a certain period. Such restrictions (to upstreaming cash) have to be taken into account when structuring private equity transactions.

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

A number of family offices are playing an active role in Swiss private equity-style transactions, both in co-investments with private equity funds and as sole investors. In particular, in the latter case, their approach can differ from traditional private equity firms, e.g. in terms of structuring in connection with tax considerations.

## 2 Structuring Matters

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

Usually, private equity funds investing in Swiss portfolio companies set up a NewCo/AcquiCo in Switzerland as an acquisition vehicle. The NewCo is held either directly or via Luxembourg, the Netherlands or a similar structure. We have also seen AcquiCos incorporated outside of Switzerland.

Management usually invests directly in the AcquiCo rather than via a management participation company. Often, a single shareholders' agreement (SHA) is concluded between the financial investor(s) and management, which governs all aspects of the investment (governance, exit procedures, share transfers, good/bad leaver provisions, etc.). In other cases, a main SHA is concluded between the financial sponsors and a separate, smaller SHA with management.

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

The acquisition structure is mainly tax-driven (tax-efficient repatriation of dividends/application of double taxation treaties, tax-exempt exit). Directly investing in the AcquiCo may allow Swiss-domiciled managers to realise a tax-free capital gain on their investment when the AcquiCo is sold on exit.

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

A Swiss NewCo often has only one class (or a maximum of two classes) of shares. Preferential rights, exit waterfall, etc. are implemented on a contractual level in the SHA. NewCos incorporated abroad often have several classes of shares.

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

Structuring is, in principle, not fundamentally different from majority investments. Pre-existing structures are often maintained to a certain extent. However, on a contractual level, increased protection is sought (veto rights, 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, GmbH) are used, which have the advantage of being treated as transparent for US tax purposes.

The stock corporation is governed by a board of directors that has a supervisory function and resolves on strategic and important issues (appointment of senior management, etc.). A director is elected *ad personam*; proxies (e.g. in the case of absence at meetings) are not possible.

Day-to-day management is normally delegated to management, based on organisational regulations. They often contain a competence matrix defining the competences of each management level and the decisions that need approval by the board or even shareholders.

Such division of competence is – together with board composition, quorum requirements, etc. – also reflected on a contractual level in the SHA.

Neither the organisational regulations nor the SHA are required to be made publicly available in Switzerland; only the articles of association.

Our comments in question 3.1 regarding stock corporations apply largely also to LLCs.

In June 2020, the Swiss federal parliament approved a general corporate law reform. The aim of the reform is to modernise corporate governance by strengthening (minority) shareholder rights and, for listed companies, promoting gender equality in boards of directors and in senior management. Furthermore, the new law will facilitate company formation, makes capital rules more flexible (e.g. allows for capital to be denominated in a foreign currency) and amends the rules on corporate restructurings. The amendment will enter into force on 1 January 2023.

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

If a private equity investor holds a minority of the voting rights, its veto rights usually depend on the stake held: while a small investor (up to 20%) normally enjoys only fundamental veto rights aimed at the protection of its financial interest (dissolution, *pro rata* right to capital increases, no fundamental change in business, maximum leverage, etc.), investors holding a more significant minority stake (20–49%) usually also have veto/influence rights regarding important business decisions and the composition of senior management. The exit rights for private equity investors holding a minority position are usually heavily negotiated.

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

At shareholder level, veto rights may be created by introducing high quorums for certain shareholders' decisions in the articles of association and the SHA. Such veto rights are generally regarded as permissive, provided the arrangement does not lead to a blockade of decision-taking in the company *per se*.

At board level, individual veto rights of certain board members cannot be implemented based on the articles of association or other corporate documents. However, such individual veto rights are regularly incorporated in the SHA; i.e. the parties agree that the board shall not take certain decisions without the affirmative vote of certain nominees. A board decision taken in contradiction to such contractual arrangement would still be valid but may trigger consequences under the SHA. Furthermore, directors are bound by a duty of care and loyalty *vis-à-vis* the company. If abiding by instructions given by another person based on contractual provisions leads to a breach of such duties, the board member may not follow such instructions and will likely not be in breach of the SHA (at least if the latter is governed by Swiss law).

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

Purely from its position as a shareholder, in principle, a private equity investor does not have such duties; shareholders of a Swiss stock corporation do not have any duty of loyalty.

However, directors, officers and management have a duty of care and loyalty towards the company and, to a certain extent, also to the minority shareholders. Under special, limited circumstances, a private equity investor or an individual acting for it may be regarded as *de facto*/shadow director of the company and, consequently, also be bound by such duties. The claim that a shareholder or one of its representatives is a shadow director might be successfully made if such person has *de facto* acted as an officer of the company, e.g. by directly taking decisions that would actually be within the competence of the board, etc.

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

SHAs are common in Switzerland and are normally governed by Swiss law. The parties are largely free to determine the rights and duties but there are certain limitations. The most important are:

- an SHA may not be unlimited in time/valid during the entire lifetime of the company, but may have a maximum term of *ca.* 20–30 years; and
- as per mandatory corporate law, directors must act in the best interests of the company (duty of care and loyalty), which may hinder the enforcement of the SHA if its terms would conflict with such duties.

An SHA is only enforceable against its parties. There is a debate in Swiss legal doctrine as to what extent the company itself may be party to an SHA and be bound by its terms. While a majority acknowledges that the company may fulfil some administrative duties, entering into further obligations is questionable.

Non-compete obligations of the shareholders in favour of the company are typically enforceable if the respective shareholders are (jointly) controlling the company. Furthermore, non-compete obligations need to be limited to the geographical scope and scope of activity of the company.

To secure share transfer provisions of the SHA, the parties often deposit their shares with an escrow agent under a separate share escrow agreement. Sometimes, SHAs also provide for penalty payments in case of breach.

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

On a practical note, at least (i) one person with individual signatory power residing in Switzerland, or (ii) two individuals with joint signatory power both residing in Switzerland, must be able to fully represent the company (entry into the commercial register). It is not necessary that such persons are board members (but, e.g. managers). Additional individual or collective signatory rights may also be granted for persons residing outside Switzerland.

Directors, officers and managers of the company (including nominees of the private equity investor) have a duty of care and loyalty towards the company and must safeguard the (sole) interest of the portfolio company, even if such interest is contrary to the interest of the appointing private investor. Under special, limited circumstances, a private equity investor or an individual acting for it may be regarded as a *de facto*/shadow director of the company and, consequently, also be bound by such duties. To prevent such a scenario, decisions should solely be taken by the competent bodies.

Further, directors, officers and managers may be held liable in case of non-payment of certain social security contributions and taxes by the company.

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

In case of a conflict of interest, the concerned director must inform the other board members and abstain from participating in the respective discussion and decision-making process. In typical Swiss private equity set-ups with one or few financial sponsor(s) that are each represented on the board, issues related to conflicts of interest are of limited relevance in practice.

## 4 Transaction Terms: General

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

If certain turnover thresholds are met, a Swiss merger filing must be made. Unless the Competition Commission (CC) decides to initiate a four-month phase II investigation, clearance is granted within one month (phase I) after filing the complete application. It is strongly recommended that a draft filing be submitted for review by the Secretariat (which usually takes one to two weeks) to make sure that the filing is complete (thereby triggering the one-month period) and not rejected as incomplete 10 days after filing.

For transactions regarding certain industries, governmental approvals must be obtained (e.g. banks, telecoms, etc.). The impact on the timetable depends on the respective regulation and on the authorities involved. 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?

Since debt financing has been easily available, buyers became more willing to enter into binding purchase agreements prior to securing financing.

Further, given the recent sellers' market, share purchase agreements had tended to be more seller-friendly (e.g. with regard to representations and warranties ("R&W"), etc.), albeit not as extreme as in the preceding years.

These trends have not been majorly affected by the COVID-19 Pandemic.

As a general observation, typical Swiss share/asset purchase agreements still tend to be significantly shorter in length than US/UK agreements – a consequence of Switzerland's civil law system.

## 5 Transaction Terms: Public Acquisitions

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

Anyone who acquires equity securities that, when added to equity securities already owned, exceed the threshold of one-third of the voting rights (irrespective of whether these voting rights are exercisable) of a Swiss listed company, is obliged to make an offer for all listed equity securities of the company (mandatory tender offer), barring exemptions granted by the Swiss Takeover Board. The target company may, however, have either increased such threshold in its articles of association to a maximum of 49% of the voting rights (opting up), or completely excluded the obligation to make an offer (opting out).

Further, anyone who exceeds certain thresholds of the voting rights in a Swiss listed company (the lowest triggering threshold is 3%) is obliged to make a notification to the company and the stock exchange (disclosure obligation).

Moreover, to carry out a statutory squeeze-out or a squeeze-out merger subsequent to a public tender offer, the bidder must hold at least 98% (for a statutory squeeze-out) or 90% (for a squeeze-out merger), respective of the voting rights of the target company. Voluntary tender offers are regularly made subject to a minimum acceptance condition, which, however, does normally not exceed two-thirds of the target company's shares (depending on the circumstances, the Takeover Board may grant exemptions). Thus, the bidder can typically not structure the offer in a way to exclude the risk of ending up holding less than 90% and, consequently, not being able to squeeze out the remaining minority shareholders. In practice, however, bidders reach squeeze-out levels in most Swiss public acquisitions.

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

Both takeover parties can agree on break fees unless the fee payable by the target company will result in coercing shareholders to accept the offer or deter third parties from submitting an offer. As a rough rule of thumb, break fees should not considerably exceed the costs in connection with the offer. The parties must also disclose such agreements in the offer documents.

In addition, block trades secure an improved starting position and decrease the likelihood of a competing bid. An alternative would be tender obligations from major shareholders. These would, however, not be binding in the event of a competing offer.

## 6 Transaction Terms: Private Acquisitions

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

The locked-box mechanism (with anti-leakage protection) preferred on the sell-side, and NWC/Net Debt adjustments, based on closing accounts, preferred on the buy-side, are equally common in Switzerland. However, the seller-friendly market in recent years has led to an increase in the use of the locked-box mechanism. Earn-outs and vendor loans have been seen less often recently.

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

Usually, a customary set of 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 warranty and indemnity (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 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). 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 up for lock-up undertakings six to 18 months after the IPO. Therefore, SHAs among private equity investors and agreements with directors and managers should provide for respective undertakings.

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

This is heavily dependent on the general market conditions. If an IPO is considered, dual-track processes are often seen. However, if an IPO is not the preferred route at the beginning, a trade sale (auction) process will often just take place. Dual-track processes are being pursued until very late in the process, although parties try to make their final decision before the intention to float is published. Preferably, the timelines for both tracks are aligned so that the analyst reports and investor feedback on the IPO track are available simultaneously with the binding offers on the trade sale track. This allows the decision on the track to be made once there is a relatively clear view on the valuation.

**7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?**

Several Swiss companies have gone public via foreign special purpose acquisition companies (SPACs) at foreign stock exchanges. Mergers with foreign SPACs are possible, but highly complex due to their cross-border nature. In contrast, a combination with a Swiss SPAC presents a more "natural" match for Swiss targets from a regulatory, legal and tax perspective and offers the opportunity to become listed on an attractive listing venue within a favourable regulatory environment. Although the listing of Swiss SPACs has been facilitated due to a revision of the regulatory framework (amendment of the listing rules of the SIX Swiss Exchange and other directives; issuance of a new SIX directive on the listing of SPACs), it remains to be seen whether SPACs listed in Switzerland will be used, as the new regulatory regime is still recent. Until today, one SPAC has been listed in Switzerland.

A Swiss SPAC can acquire a target by a private share purchase transaction or a contribution in kind and the SPAC will continue to be listed as a new holding company of the target. A statutory merger or similar transaction is not required. Once a potential target company is identified, shareholders of the SPAC need to vote on the de-SPAC transaction at a special general meeting. SPAC shareholders opposing the transaction are granted redemption rights. In order to ensure that appropriate information is available to the SPAC shareholders, the SPAC has to prepare and publish a de-SPAC specific information document containing, *inter alia*, a description of the target and its business (including the main risks and a business forecast), as well as relevant financial information and information on the corporate governance of the target. In addition, an independent review of the appropriateness of the offer, also regarding the target's valuation, must be made by a recognised accounting firm and its report must be included in the information document. If the SPAC transaction involves a listing of new SPAC shares by more than 20% or a public offering, a prospectus must be prepared, and all information can be included in the prospectus.

## 8 Financing

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

Private equity investors usually provide financing in the form of subordinated loans. In the context of leveraged buyouts, investors will typically use senior and junior debt in the form of credit facilities provided by financial institutions. In the context of acquisitions, debt providers usually require that existing debt is refinanced at the level of the acquisition debt providers. Security released in connection with the refinancing typically serves as collateral for the new acquisition financing. The ability of Swiss target group companies to provide collateral is limited under Swiss law. Upstream and cross-stream security may only be granted if certain prerequisites are met, and only in the amount of the relevant Swiss company's freely distributable reserves.

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

Certain limitations on leverage result from the thin capitalisation rules applied by Swiss tax authorities with respect to related-party debt. Interest paid on amounts of debt exceeding certain thresholds may be requalified as a hidden dividend if paid to a shareholder or a related party of a shareholder. Consequently, such interest would not be tax-deductible and subject to 35% dividend withholding tax.

The same applies if debt is provided by a third party but secured by a shareholder. The Swiss tax authorities publish maximum safe haven interest rates for intercompany loans on an annual basis. Higher interest rates can be justified with a third-party test.

Furthermore, there are restrictions on Swiss companies granting loans or providing security that are of an upstream or cross-stream nature (see question 8.1 above).

In order to avoid interest withholding tax of 35%, financing of a Swiss acquisition company must comply the so-called 10/20 non-bank rules and foresee transfer restrictions with respect to the number of non-bank lenders. A proposed reform foresees the abolition of such withholding tax. The reform is currently expected enter into force on 1 January 2023; however, it is subject to a popular vote, which is likely to take place in autumn 2022.

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

Until recently, M&A activities remained a major driver for debt-financing transactions. It is expected that M&A will continue to drive debt-financing transactions, although perhaps not to the same degree as in 2021 due to the conflict in Ukraine and resulting uncertainty.

In 2022, the COVID-19 pandemic and a state-backed credit support programme for Swiss companies remain relevant. In order to fight the financial consequences of the COVID-19 pandemic for small and medium-sized businesses, such businesses may request from Swiss commercial banks emergency credit lines that are guaranteed by the Swiss government. Due to the restrictive covenants of these emergency credit lines (*inter alia*, a dividend prohibition on a single entity level), an acquirer will need to refinance these emergency credit lines with priority.

In contrast to other jurisdictions, benchmark interest rates remain negative, which will continue to shape the Swiss debt-finance market.

## 9 Tax Matters

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

Switzerland is not known as a very attractive location for the establishment of private equity funds, mainly due to the Swiss withholding tax (*Verrechnungssteuer*) and securities transfer tax (*Umsatzabgabe*) regimes. Therefore, private equity funds are typically established in jurisdictions like Cayman Islands, Guernsey, Jersey, Luxembourg or Scotland.

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.

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

A capital gain on the sale of shares that have been acquired at fair market value (FMV) by a Swiss resident manager will generally qualify for a tax exemption. However, the determination of FMV is often difficult for non-listed shares and as fall-back, a formula value can be applied. There are no specific tax reliefs or tax provisions for management share participations, except for blocking period discounts (6% per blocking year for a blocking period of up to 10 years with a maximum discount of 44.161%) if shares are acquired below FMV. The taxable income is calculated as the difference between the (reduced) FMV of the shares and the price at which they are sold to the employee (if the latter is lower).

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

Swiss-resident managers generally try to achieve a tax-exempt capital gain upon the sale of privately held shares. In order not to qualify as salary (like synthetic bonus schemes), the managers should have full ownership rights (dividend, liquidation, voting rights). A tax-neutral roll-over may be structured in certain circumstances. Whether the sale of shares under a management participation qualifies as a tax-exempt capital gain or as taxable salary is a case-by-case decision, since preferential terms (like sweet equity) or a later investment at a formula value could lead to (partial) taxable salary for the managers upon sale and social security charges for the manager as well as the Swiss employer (as well as wage withholding tax, if applicable). Thus, it is recommendable to confirm the consequences of a specific management participation in an advance tax ruling (Swiss social security authorities generally follow the Swiss employment income tax treatment).

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

The substance of foreign acquisition companies and their qualification as beneficial owners of the shares in the Swiss target in order to benefit from a Swiss dividend withholding tax reduction are 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 9.2. 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.

## 10 Legal and Regulatory Matters

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

The Swiss corporate law reform (see question 3.1 above) will enter 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 will be 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 a *de facto* abolition of bearer shares. Subject to few exceptions (notably companies with shares listed on a stock exchange), Swiss stock corporations are no longer allowed to issue bearer shares. Existing bearer shares had to be converted into registered shares by 30 April 2021. Bearer shares that were still outstanding in May 2021 were converted by the competent authorities.

On 1 January 2020, the Financial Services Act (FinSA) and Financial Institutions Act (FinIA) entered into force, changing the Swiss financial regulatory landscape significantly. The 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.

In a nutshell, the revision of the CISA abolished the former concept under which both product-related requirements and point-of-sale duties in connection with investment funds were linked to a broad notion of "distribution" with very limited exceptions, limiting the possibilities of foreign private equity funds to raise funds in Switzerland without triggering regulatory requirements. The new regime is more closely integrated with general financial instruments regulations and enables the offering of foreign investment funds, 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 regulator FINMA and/or having to appoint a Swiss paying agent and representative. Furthermore, the licence/supervision requirement for distributors of collective investment schemes was abolished with the revised CISA. However, activities in or into Switzerland, aimed at the purchase of fund interests by Swiss investors, may qualify as a "financial service" 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 the supervisory authority (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 2023.

#### 10.2 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, 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.

On 25 August 2021, the Swiss Federal Council presented the basic cornerstones of a prospective foreign investment control regime in Switzerland. However, the details of the proposed legislation are yet to be specified.

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

The legal DD usually covers the following areas: corporate; financing agreements; business agreements; employment; real property/lease; and IP/IT, data protection and litigation. The handling of compliance and regulatory matters depends on the specific case. Typically, an external legal counsel is engaged to conduct a red flag legal DD of two to four weeks' duration.

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

In DD as well as transaction agreements, a focus on compliance of target companies with anti-bribery, anti-corruption and economic sanctions has increased in recent years.

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

Under special, limited circumstances, a private equity investor or an individual acting for it may be regarded as a *de facto*/shadow director of the company and, consequently, be bound by directors' duties (see question 3.6).

A private equity investor that (solely or jointly) controls a portfolio company that has infringed competition law could be made jointly and severally liable for paying the resulting fine. While it is possible that a portfolio company may be made liable for the liabilities of another portfolio company, this is a less likely scenario. See also section 11 below.

Under normal circumstances, it is highly unlikely that a portfolio company will be liable for another portfolio company.

## 11 Other Useful Facts

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

In April 2014, the European Commission imposed a €37 million fine on Goldman Sachs for antitrust breaches committed by a portfolio company that was formerly owned by its private equity arm, GS Capital Partners. GS and the portfolio company were held jointly and severally liable for the fine. GS was held liable on the basis that it exercised decisive influence over the portfolio company, although GS was not alleged to have participated in, been aware of or facilitated the alleged cartel in any way. Even though in Switzerland no such precedents in relation to private equity companies exist so far, it is possible that the Swiss CC could follow the European Commission's line of thinking. In Switzerland, holding companies tend to be found to be jointly and severally liable for the antitrust fines of their subsidiaries. Private equity investors should, therefore, implement a robust compliance programme in their portfolio companies to avoid antitrust law infringements.

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Luca Jagmetti has several speaking engagements on asset transactions, legal DD and other M&A topics (e.g. a Course on Commercial Law of the University of St. Gallen; an LL.M. programme at the University of Zurich). According to *The Legal 500* (2016), he is "very knowledgeable and speedy". *IFLR* (2021) lists him as highly regarded.

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Bär & Karrer is a leading Swiss law firm with more than 170 lawyers in Zurich, Geneva, Lugano, 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.

- 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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# Taiwan

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## 1 Overview

**1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?**

In local practice, recently the most common types of private equity ("PE") transactions have been related to technology, media and telecommunications ("TMT") industries, while some traditional industries such as the chemical industry and people's livelihood consumption enterprises have also been increasingly favoured by large international PE investors. Recently, a series of significant deals led by PE funds were completed, including Magicapital's take-private acquisition of On-Bright and Ili Technology, KHL Capital's investment into telecom service provider Taiwan Star, and AMP Capital's investment into offshore wind farm pioneer Swancor.

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

Factors encouraging PE transactions normally include, for example: (i) from the perspective of a portfolio company, the need to re-structure the company from a financial and/or operational viewpoint with the assistance of PE firms; and (ii) from the perspective of PE firms, the potential increase of value of the portfolio company if the company is benefitted from the resources (strategically or otherwise) that can be brought into the company by PE firms.

With respect to inhibitory factors, the attitude of the government would be the main factor affecting PE transactions. For example, the government might not necessarily wish to see large or reputable companies delisted from the exchanges in Taiwan. Also, the government would be concerned about the protection of minority shareholders under a take-private transaction. In addition, some government officials seem to still hold a rather conservative view towards PE firms and transactions, thinking that PE firms focus more on relatively short-term investment performance and would not necessarily be good for local stakeholders (e.g., industries, employees, etc.).

**1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

Given the uncertainty surrounding the COVID-19 pandemic, it is difficult to gauge the longer-term impact on industry performance. Therefore, we expect that PE firms will be more conservative towards the economic outlook and cherry-pick the underlying companies/industries or even halt transactions. However, we believe that there will still be PE firms that wish to proceed with transactions under which the target is undervalued, or even financially distressed, but with large potential to recover due to, for example, its core technologies or competitive edge among the industries. To our knowledge, although several relief and economic stimulus packages have been proposed or implemented by government authorities, they are generally aimed to provide financial assistance to enterprises that were severely affected by the outbreak of COVID-19, without specifically addressing any issues that may be faced by PE or PE activities.

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

No, not to our knowledge. In local practice, traditional PE firms are still the most common investors executing PE-style transactions in Taiwan.

## 2 Structuring Matters

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

In local practice, it is very common to see a PE firm establishing a local special purpose vehicle ("SPV") to acquire the shares of the portfolio company in Taiwan.

Additionally, for a public transaction under which the PE investor wishes to acquire 100% of the shares of the Taiwan company, the following two approaches are commonly considered and adopted:

(i) two-step approach: the PE investor firstly launches a tender offer to acquire more shares of the target company, followed by a share swap to acquire the remaining shares; and
(ii) one-step approach: the PE investor carries out a share swap to acquire the shares of the target company directly.

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

The main reasons for setting up a local SPV for acquisition (as indicated under question 2.1 above) are tax efficiency and simplicity in transaction structure and related actions.

With respect to approaches (i) and (ii) as described in question 2.1, a PE investor may tend to adopt approach (i) (i.e., launching a tender offer first to acquire more shares of the company) if it cannot be certain whether the proposed M&A will be passed by the shareholders' meeting.

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

In Taiwan, the equity structure for PE transactions should vary from case to case, and there is no typical way of equity structuring in PE transactions.

While the arrangement of original major shareholder/management rollover is increasingly popular in Taiwan, it is commonly arranged that the rollover participants hold the equity of an offshore entity upon closing of the PE transactions.

Similar to many other jurisdictions, carried interest is the principal part of the compensation to the general partner ("GP") of a PE fund.

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

In local practice, it is rare for a PE investor to take a minority position. If a PE investor is taking a minority position in a portfolio company, it is anticipated that the minority PE investor would wish to include clauses that may protect the interest of the minority shareholders, such as tag-along rights, right of first refusal, and even veto rights for certain matters. A minority PE shareholder may also wish to have one or more board seats, depending on the percentage of shareholding, in order to have the information rights that entitle a director.

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

In Taiwan, the range of equity allocated to the management varies from case to case, and there is no typical range in this regard. According to our experience, the management may be entitled to equity pursuant to an employee stock ownership plan ("ESOP") or similar arrangement under which a certain portion of equity vests after a certain period of time and/or is based on performance of the target company. It is also common that PE or the target company may have the right to purchase the equity held by the management at a certain price in case of their departure.

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

Whether a management equity holder is treated as a good leaver or bad leaver varies depending on individual circumstances. Generally speaking, a PE firm would tend to treat a management equity holder as a "good leaver" if the leaver's conduct is without fault (e.g., death, disability, retirement), and as a "bad leaver" if there is, to some extent, fault on behalf of the leaver (e.g., dismissal for cause, breach of the shareholders' agreement, failure to achieve certain targets or expectations, etc.).

## 3 Governance Matters

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

There are no typical governance arrangements for a PE portfolio company if the PE investor acquires 100% of the shares of such portfolio company.

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

If the PE investor acquires 100% of the shares of the portfolio company, the portfolio company will be wholly controlled by the PE investor, so there should be no issue regarding veto rights.

In case a PE investor takes a minority position, the PE investor may wish to have veto rights over activities that will materially affect the company, such as M&A, issuance of securities, change to the business plan of the company, material transactions and capital expenditure, etc. The veto rights may be entitled to the PE investor at the level of shareholders' meeting or, in case the PE investor nominated any director of the company, the board meeting.

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

From a contract point of view, there is no limitation on the effectiveness of veto arrangements under Taiwan law, and if a party is in breach of the veto arrangement, the other party may seek remedies against the breaching party under the contract. If the contract also stipulates that the veto arrangement should be reflected in the constitutional document (i.e., articles of incorporation ("AOI")) of the company, not all of the thresholds expressly specified in the Taiwan Company Act for the resolutions of shareholders and directors may be raised by the AOI. Therefore, any attempt to reflect the veto arrangement in the AOI that contradicts the statutory voting thresholds may be deemed null and void.

Also, the Taiwan Company Act permits shareholders of non-public companies to have contractual voting arrangements. Therefore, the enforceability of voting arrangements among shareholders of a public company might not necessarily be recognised by the court.

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

Under local law and practice, there are no specific duties owed by a PE investor to minority shareholders, except where the

PE investor appoints any directors in the company, in which case such directors shall have fiduciary duties under the Taiwan Company Act.

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

From a Taiwan legal perspective, choice of foreign law (governing law) and submission to exclusive jurisdiction of a foreign country (jurisdiction) will be recognised and given effect by the courts of Taiwan, provided that Taiwan courts may refuse to apply the relevant provisions of foreign law to the extent such courts hold that: (i) the application of such provisions would be contrary to the public order or good morals of Taiwan; and (ii) such provisions would have the effect of circumventing mandatory and/or prohibitive provisions of Taiwan law. For submission to an exclusive jurisdiction of a foreign country, a submission to jurisdiction clause and the relevant foreign court judgment would be generally recognised and enforced by Taiwan courts on a reciprocal basis.

The obligations of shareholders under non-compete and non-solicit provisions are generally recognised by the courts. However, if a shareholder is an executive officer of the target company and his shareholding is limited, his non-compete obligations after termination of service agreement may be subject to the court's review (and the important factors that may affect the validity of such non-compete obligations include proper consideration and period, etc.).

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

There are no specific legal restrictions or other requirements with respect to a PE investor's appointment of any directors in portfolio companies, except that such directors shall have fiduciary duties under the Taiwan Company Act, which include the duty of loyalty to the company. Also, from a Taiwan law perspective, the individual(s) appointed by a PE investor to act as the director(s), and the PE investor itself, would be deemed director(s) of the target company for all purposes of the director's fiduciary duties. Therefore, if any individual appointed by a PE investor to act as the director breaches his fiduciary duties and causes damage to the target company, the individual and the PE investor may be jointly and severally liable for such damage.

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

Theoretically speaking, directors nominated by a PE investor are subject to their fiduciary duties to the target company. However, in local practice, the risk of conflict of interest may be remote. First of all, as PE investors normally acquire 100% equity of a target company, the best interest of the company is usually aligned with that of the PE investor. Also, where the target company has more than one shareholder (e.g., PE investor and rollover participants), the governance of the target company would be carried out in accordance with the shareholders' agreement, and the decision made in the board meeting should be a result that reflects the principles and voting arrangements agreed by all shareholders in the shareholders' agreement.

## 4 Transaction Terms: General

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

In Taiwan, PE acquisitions are often subject to foreign investment approvals and an antitrust review process. For those target companies that are in a regulated industry, approval from the competent authority would also be required. Therefore, whether and how regulatory approvals can be smoothly obtained is a critical issue to the completion of a PE transaction in Taiwan, which would materially impact the timetable for PE transactions in Taiwan.

Disclosure obligations and financing are normally not major issues impacting the timetable for transactions in Taiwan.

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

Acquisition by PE investors has risen strongly in recent years. The major reasons include the local regulators' policies (being neutral to such transactions), the relatively low price-to-earnings ratio of Taiwan listed companies, and favourable interest rates in local financing markets. Also, use of warranty and indemnity ("W&I") insurance has become more common in local M&A transactions, especially for take-private transactions by PE investors.

## 5 Transaction Terms: Public Acquisitions

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

With respect to a public-to-private transaction where the target company will be delisted, a particular challenge is the regulatory threshold of shareholders' resolution. Where the target company is to be delisted upon closing, such transaction would require approval of two-thirds of the total number of the issued shares of the target company. It is noteworthy that the government has even proposed to raise the threshold from the current two-thirds to three-quarters, although this proposal is still under discussion. The common way to deal with this challenge is by (1) first launching a tender offer to acquire more shares before carrying out the M&A requiring such a high threshold, and/or (2) entering into an agreement with existing major shareholder(s) who could help obtain a sufficient number of votes to support the proposed transactions.

We do not see any particular challenges with respect to the financing of PE investors in public-to-private transactions.

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

Under public acquisitions, it is common to see a PE investor request the seller to accept an exclusivity provision, under which the seller may not look for other buyers after the signing of the definitive agreement.

## 6 Transaction Terms: Private Acquisitions

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

In local practice, PE investors typically prefer to use cash consideration for private acquisitions on both the sell-side and the buy-side.

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

Typically, the package of warranties offered by the PE seller in a private acquisition is similar to those customarily provided by the sellers in normal M&A transactions. With respect to indemnities, a PE seller would normally tend not to offer a long period during which the buyer may seek for indemnities; otherwise the PE firms may not be able to have a clear exit or make the distribution to its investors soon after the closing of the transactions. We notice that in some cases, W&I insurance was used to bridge the gap.

In local practice, it is not typical to have warranties/indemnities separately offered by the management team to a buyer under private acquisitions.

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

In local practice, other than certain typical pre-closing covenants such as "standstill", a PE seller normally would not agree to provide post-closing covenants for non-competition, etc. With respect to indemnities, as advised under question 6.2, normally a PE seller would tend not to offer a long period during which the buyer may seek for indemnities.

In local practice, management teams who are also selling shareholders would be required to either enter into a certain retention arrangement or undertake not to compete with the target company for a certain period of time after the closing.

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

In local practice, W&I insurance has become increasingly popular recently. Our observation is that the buyer may consider obtaining W&I insurance when a seller needs a clear exit (such as a PE seller) or the nature of the transaction makes the post-closing indemnity for breach of representations less meaningful (such as a public company deal without a major selling shareholder).

The provisions of W&I insurance may vary from case to case, and to our knowledge, in local practice, there are no typical (i) excesses/policy limits, (ii) carve-outs/exclusions, or (iii) costs for such insurance, which would largely depend on the size of transaction, the business of target company and the due diligence exercise of the buyer.

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

In addition to the survival period of the representation, it is common that the aggregate liabilities of the sellers would be capped at 100% of the purchase price, and liabilities for breach of non-fundamental representations would be capped at 20–30% of the purchase price. On the other hand, the parties would usually consider the nature of the target company's business and the deal size when negotiating the amounts of *de minimis* and basket thresholds.

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

We have seen escrow or holdback arrangements in some cases but we do not think they are common in local PE deals.

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

According to our experience, when the seller needs comfort, a PE buyer may present to the seller a commitment letter issued by it to its SPV (the buyer), indicating its commitment to make equity investment in the SPV for the transaction. With respect to debt finance, a PE buyer (for its own benefits as well) would obtain a certain fund commitment from the lenders before signing a definitive agreement with the seller, which may also be presented to the seller.

In local practice, the seller (as a third party) usually has no right to enforce such commitment letters pursuant to the terms and conditions thereof. However, theoretically speaking, if the definitive agreement for the transaction and the relevant commitment letters are governed by Taiwan law, the seller may have a right to enforce the relevant commitment letters for and on behalf of the buyer for the general benefits of all creditors of the buyer (instead of in the name of the seller and for its own benefit).

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

According to our experience, "break fee" arrangements are not prevalent in local practice.

## 7 Transaction Terms: IPOs

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

A Taiwanese initial public offering ("IPO") may not be an attractive way of exit due to the relatively low price-to-earnings ratio of the Taiwan stock market, and PE investors usually prefer to carry out IPOs in other jurisdictions. However, due to the special relationship between Taiwan and China, the approval of Taiwanese regulators for a PE investor's acquisition of a Taiwanese target company may be given on the condition that the PE investors shall undertake not to have the target company list in stock exchanges in China or Hong Kong in the future, which may limit the IPO exit by PE investors.

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

In local practice, for an IPO, the directors and supervisors of such company, as well as the shareholder(s) holding more than 10% of the shares of the company ("10% Shareholder"), are required to place their shares with the Taiwan Depository & Clearing Corporation ("TDCC") for central custody. The total number of shares placed in custody shall also reach a certain percentage (5–25%, depending on the number of total issued shares) of the shares of the company.

The required period for such central custody is one year. After the first half-year of the IPO, the directors, supervisors and 10% Shareholders will be able to retrieve 50% of their shares, and the remaining 50% may be retrieved after the second half-year of the IPO.

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

From our observation, the dual-track exit process is not common in Taiwan. As mentioned above in question 7.1, an IPO does not seem to be considered an exit priority, so there were many more cases where PE sellers exited through a sale.

### 7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?

"SPAC listing" in the U.S. has had an impact on the M&A activities in Taiwan. A couple of de-SPAC transactions involving Taiwanese companies were announced in the previous year. While a de-SPAC may, therefore, be considered by PE sellers as a new way to exit, the recent warning from US regulators that the SPAC market may be "overheating" amplified market uncertainty. Also, it is our understanding that the costs of a de-SPAC transaction could be similar to a traditional listing in the U.S., which might not necessarily be affordable as Taiwanese start-ups are usually smaller in scale. While there may be more SPAC-related transactions in Taiwan in the future, it is difficult to predict whether PE sellers will tend to deem a de-SPAC transaction a regular way to exit.

## 8 Financing

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

The most common source of debt finance used in PE transactions is bank loan – specifically, syndicate loans extended by domestic and/or foreign banks. Other debt financing instruments are rarely seen in local practice.

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

As indicated above under question 8.1, the most common source of debt finance used in PE transactions is bank loan. While there are no legal requirements or restrictions that would specifically impact the nature or structure of the debt financing of a PE transaction, from our experience, Taiwan regulators may have concern if the loan granted by domestic banks exceeds 60% of the consideration for the transaction.

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

There are no particular recent trends in the debt financing market in Taiwan. Most PE investors still prefer to arrange for bank loans (as described above in question 8.1) as the source of debt finance.

## 9 Tax Matters

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

In Taiwan, a tax implication normally considered in PE transactions is, from the perspective of the seller, whether the transaction would be subject to the securities transaction tax (0.3% of the transfer price) on the sale of the securities and/or the income tax (for which the highest tax rate is up to 40% for individuals).

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

As indicated above, it is commonly arranged that the management (rollover participants) hold the equity of an offshore entity upon closing of the PE transactions, in which case the focus would be more on the tax law of the jurisdiction where the offshore entity is incorporated. However, a Taiwanese individual's non-Taiwan-sourced income from his/her equity in the offshore entity should also be included in the calculation of the alternative minimum tax of Taiwan.

In case the management (rollover participants) holds the equity of an onshore entity upon closing of the PE transactions, the tax implication would depend on the type of equity instruments granted to the rollover participant. For example, in case of employee stock options, the Taiwanese individual holder will be taxed (income tax) on the difference between (i) the "then-fair value" when the option is exercised, and (ii) the exercise price of the option.

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

See question 9.2.

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

The M&A Act just underwent an amendment in June 2022, under which:

(1) The tax on M&A share consideration received by individual shareholders of an acquired start-up company (defined as a non-public Taiwanese company not older than five years) can be deferred, subject to certain requirements and restrictions. We believe this would become a tax incentive for M&A involving start-ups companies.

(2) The type of identifiable intangible assets generated by an M&A, as well as the calculation of the amortisation of such assets, are clearly provided for. We believe such amendment will provide more clarity for the calculation of the tax implication from the perspective of acquirer in an M&A transaction.

## 10 Legal and Regulatory Matters

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

There have been several significant legal developments in recent years:

(1) Taiwan's M&A Act was amended in June of 2022. The main amendments include, among others:
    (a) The newly amended M&A Act requires that the directors' personal interests and the reasons for approval or dissent to the resolution of an M&A be stated on the shareholders' meeting notice, so that the shareholders would be informed prior to the shareholders' meeting.
    (b) Before the amendment, dissenting shareholders must abstain from voting in order to exercise the shareholders' appraisal right. Under the amendment, the dissenting shareholders may choose to vote against the proposal and still exercise the appraisal right.
    (c) Pursuant to the M&A Act, if the target company is significantly smaller than the acquiring company (i.e., "asymmetric M&A"), the acquiring company's shareholders' meeting is not required, and a special resolution of the board would suffice. Pursuant to the amendment, such "asymmetric M&A" include the situation where (i) the new shares issued by the acquiring company are not more than 20% of its voting shares, or (ii) the consideration paid by the acquiring company does not exceed 20% of the book value of the target. The threshold for (ii) above is changed from 2% to 20% of the book value under the amendment.

(2) The government has proposed to amend the Statute for Investment by Foreign Nationals, which governs foreign investments, by replacing the current prior approval system with a post-closing notification system for deals under a certain size. The proposed amendment aims to shorten the foreign investment review process. By and large, the proposed amendment is expected to be friendlier to cross-border M&A deals; however, there is no definitive timeline for the legislative process.

(3) The government made relevant amendments to regulations governing PRC investors' investment in Taiwan to prevent the circumvention of the investment control. For example, according to the amendments: (i) stricter criteria were adopted for identifying PRC investment made through third-area intermediary; and (ii) PRC investors wishing to control a Taiwanese company (other than those listed on the TWSE or Taipei Exchange or traded over the Emerging Market of the Taipei Exchange) via contractual arrangement are also required to apply for regulatory approval. In addition, investment directly or indirectly sponsored by the Chinese Communist Party or any governmental or military agencies of PRC is severely restricted. Given so, the transaction structuring must be carefully structured to meet the requirements applicable to PRC investors for making investment in Taiwan.

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

Considering the current government's conservative attitude toward China investments, any transactions involving Chinese funding is under higher scrutiny by Taiwan regulators. Given the sensitivity of China investments in Taiwan, buyers and sellers might need to spend more time structuring their transactions to meet local restrictions/requirements. In addition, as a result of recent developments in Hong Kong, it is likely that Hong Kong will also be considered China by Taiwan regulators in the future.

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

The timeline of legal due diligence of PE transactions ("Legal DD") varies from case to case. According to our experience, it is commonly seen that the Legal DD period may take one to two months. The materiality thresholds for a PE transaction should really depend on individual cases, and the size and operation of the target company (as measured by, for example, assets and revenues) as well as the requirements of the insurer for W&I insurance, are normally the important factors in determining the thresholds. As to the scope of the Legal DD, PE investors would normally request a comprehensive Legal DD on the target company.

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

Not to our knowledge. However, the relevant issues would definitely be a concern for PE investors and would need to be checked during the Legal DD.

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

No, except for the following rule regarding "piercing the corporate veil" under the Taiwan Company Act. According to the Taiwan Company Act, if a shareholder (i.e., PE investor) abuses the status of the company (i.e., portfolio company) as a legal entity and thus causes the company to bear specific debts and it is apparently difficult for the company to pay such debts, and if such abuse is of a severe nature, the shareholder shall, if necessary, be liable for the debts. This rule is rather abstract and relatively new under Taiwan law, and its applicability is subject to a court test on a case-by-case basis.

## 11 Other Useful Facts

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

Practically speaking, PE investors wishing to invest in Taiwan must not overlook the fact that the Taiwanese authorities tend to take a more stringent attitude towards investments by foreign PE investors and, especially, PRC investors. Therefore, the whole review process by the relevant competent authorities might be time-consuming. Potential PE investors are advised to seek professional assistance from local advisors to better understand the application requirements and process, as well as the authority's policy and recent practice, to ensure that PE transactions can be conducted smoothly.

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## 1 Overview

**1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?**

The most common types of private equity ("PE") transactions in the UK centre around leveraged buyouts (in the form of share and asset acquisitions), take-private transactions, flotations and bolt-on transactions. Accompanying a majority of these transactions will also be the leveraged financing/refinancing of such deals from a variety of debt sources.

Based on a report by the British Venture Capital Association ("BVCA"), buyout investment in the UK by BVCA members increased by 31% year-on-year to £24.7 billion, of which 53% can be classed as mega buyouts. Total UK fundraising in 2021 reached £16.7 billion across 119 funds. The resurgence of PE activity that brought 2020 to a close continued in 2021, with the highest deal volumes and values ever recorded, despite uncertainty caused by COVID-19, economic and geopolitical factors.

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.

**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. Fears of impending inflation have somewhat slowed activity in recent months; we wait to see whether this trend continues. The COVID-19 pandemic potentially has more far-reaching consequences for the UK PE industry and this is discussed at question 1.3 below.

**1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

Immediately following the COVID-19 pandemic reaching its peak in March/April 2020, PE firms worked to ensure the safety of employees and customers and to shore up portfolio companies to enable them to ride out the crisis (including taking on various sources of private and government-backed financing). The impact on PE market activity was significant, with announced PE exits dropping 70% in May 2020 *vs* May 2019.

As discussed above, from H2 2020 onwards, the PE markets rebounded strongly in the UK (and internationally). Difficulties with deal sourcing and execution, such as an inability to meet face-to-face, were largely overcome, as is demonstrated by the rebound and the amount of capital being deployed in PE deals throughout 2020 to 2022. The key factors that we see as enduring are:

- Valuations: PE deals are often valued on a multiple of the target business' earnings, and specifically its EBITDA (amongst other methods). Buyers and sellers are having to agree adjustments to such EBITDA figures to reflect the unusual impact of the COVID-19 pandemic on the trading of such target businesses. How to treat such adjustments is case-specific, and a point that continues to promote debate.
- Government-backed finance: Many businesses took on government or government-backed financing during the COVID-19 pandemic. The impact of this financial support continues to impact a number of sectors. PE investors are having to focus attention on this financing in target and portfolio businesses, including its impact on their ability to add/extract value from the investment.
- New sectors: The COVID-19 pandemic has changed the way that many of us live, work and consume, which has led to the expansion of some business sectors and a contraction of others. For example, the travel sector has suffered, whereas healthcare has benefitted. The ongoing impact of COVID-19 continues to affect both existing investments and current dealmaking in such sectors.

UK Government intervention into the economy to address COVID-19 has been well-publicised. Some key impacts on the PE markets have been:

- Interest rates: Base rates across the globe were kept low, and the UK is no exception. This has led to capital seeking higher returns in sectors such as PE. This trend for low interest rates has changed sharply in Q2/Q3 2022 as interest rates have risen to attempt to curtail inflation.

- Employment markets: Establishment of furlough schemes have propped up many businesses throughout the COVID-19 pandemic and kept money in the hands of consumers. PE participants will closely follow the impact of the end of such schemes.
- Loans and insolvency protection: Many businesses benefitted from direct and indirect government financial support, and certain legal protections from insolvency. Again, the end of such schemes going forwards may have an impact on which businesses are able to continue.

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

There has been a continuation of the recent shift in non-traditional PE funds, such as sovereign wealth funds, pension plans and family offices moving beyond their primary focus on minority positions to increasingly serve in a "control" or lead investor-type capacity on direct investments in the PE space. The genesis of this trend has been the desire of these investors for greater control, reduced fees and greater returns on invested capital, particularly in the traditional PE space.

This shift in focus has created additional competition for traditional PE funds and is resulting in increased variation in the deployment of capital by these non-traditional PE investors across the capital structure. Many of these non-traditional PE funds are 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 (iv) the requirements of management (for example, if they are seeking to qualify for business asset disposal relief (formerly entrepreneurs' relief)).

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

PE investors will typically subscribe for ordinary shares in Topco. However, the ordinary shares subscribed by the PE investor typically represent only a small proportion of its funding of the transaction. The majority of the PE investor's commitment is typically funded as shareholder debt, often in the form of "payment in kind" ("PIK") loan notes, which carry a right to annual interest, which the issuer (Topco) may choose to satisfy by the issue of further loan notes. Preference shares may be used where the shareholder debt would otherwise exceed the levels permitted by transfer pricing rules or corporate interest restriction rules. The combination of ordinary share capital, preference shares, and shareholder debt held by the PE investor is commonly referred to as the "institutional strip".

Management will commonly also take an equity piece in Topco in order to ensure their interests are aligned with the PE investors. This is often referred to as "sweet equity" or "sweat equity". In some cases, in particular on a secondary buyout where they may be required to reinvest realised gains, senior executives may invest in both the institutional strip and the sweet equity. Management equity incentive plans will often be put in place to further incentivise management and other employees.

Carried interest (a performance-related share of the fund's overall profits) is typically structured through a limited partnership, with executives as limited partners. Often, the carried interest limited partnership will itself be a special limited partner in the fund limited partnership to allow carried interest to flow through the structure on a transparent basis such that executives can benefit from capital gains tax treatment on a future exit. Entitlement to carry is typically crystallised after investors have received a return of their drawn-down capital, plus any preferred return accrued and after any other pre-agreed hurdles are achieved. As noted in section 9, changes to the UK tax treatment of carried interest need to be considered.

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

The drivers described in question 2.2 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.

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, 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.

The prevalence of auction processes has also led to a general increase in the speed at which PE transactions are executed, with a rising number of auction processes being pre-empted by one bidder.

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

The UK PE M&A landscape continues to be generally favourable to sellers (both PE and non-PE). Recent trends include: (i) an increase in the number of sale processes being run as competitive auctions on a tight timetable; (ii) increased prevalence of pre-emptive bids in competitive processes; (iii) further growth in the use of warranty and indemnity ("W&I") insurance, often with low residual seller liability; (iv) shorter seller liability time periods, in many cases regardless of whether W&I insurance is being used; and (v) fewer conditions to completion of transactions, typically being only those that are mandatory and/or suspensory for the transaction in the key jurisdictions of the target's operations.

However, as with all trends, there are notable exceptions and PE buyers are well placed to negotiate positions more advantageous than these industry norms, particularly by making use of speed, commerciality and other unique advantages. We are interested to see how and if this changes if the economy stagnates.

## 5 Transaction Terms: Public Acquisitions

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

Acquisitions of the shares of public companies in the UK are generally governed by the UK City Code on Takeovers and Mergers (the "Takeover Code"). The Takeover Code imposes various rules on the conduct of such activity, generally aimed at ensuring equality of information and treatment for all of the shareholders of the target public company, including its minority shareholders. This framework is substantially more restrictive than the framework applicable to private transactions.

Provisions of the Takeover Code that are likely to be particularly relevant to PE sponsors undertaking public to private deals are: (i) specific timetables applicable to such deals; (ii) a need to announce whether or not an offer will be made for a public company within a 28-day period if the likelihood of an offer being made becomes publicly known; (iii) restrictions on the payment of break fees by public company targets on deals; and (iv) the Takeover Panel's (the entity that governs the application of the Takeover Code) increasing focus on a bidder's intentions regarding the target's business following acquisition, and the need for any plans for closures and lay-offs to be disclosed when a bidder announces its firm intention to make an offer. One year after completion of an acquisition, a bidder must confirm to the Takeover Panel whether or not it has taken the intended course of action, and publish that confirmation. Inevitable reputational consequences can follow from a failure to owner specific communicated post-offer intentions.

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

Only somewhat limited protections are available. Normal measures used on private deals, such as break fees, are generally prohibited under the Takeover Code, because of concerns that such protection mechanisms deter potential bidders from submitting competing bids and therefore maximise value for shareholders in publicly listed companies. That said, the Takeover Panel may allow break fees in very limited circumstances. This can include where the target is in financial distress and seeking a bidder, or in certain hostile situations. Such break fees are then typically limited to a 1% cap of the target's value.

## 6 Transaction Terms: Private Acquisitions

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

"Locked-box" consideration structures remain the preferred option for PE sellers in the UK market, largely due to the ease of negotiation and the certainty they provide with respect to the final consideration paid. Combined with the shorter leakage periods being obtained by PE sellers (some as low as three months post-closing) they present a highly attractive proposal when compared to a traditional completion accounts consideration structure. An additional benefit of a "locked-box" deal is that because there is no post-closing adjustment, funds can be distributed immediately following closing, allowing a PE seller to optimise investor/LP returns.

Given that the current UK market is a seller's market, "locked-box" consideration structures are commonly accepted by buyers except in limited circumstances, including where the target is a carve-out of a larger business and separate accounts are not maintained, where there have been historical issues with accounts or audits or where some other aspect of the target or the seller profile makes the deal unsuitable for a "locked-box" consideration structure. A "locked-box" consideration structure when compared to a completion accounts consideration structure will generally be seen as shifting risk from the seller to the buyer, as the buyer (together with their advisors) will need to fully diligence the relevant "locked-box accounts" and ensure they are comfortable doing the deal on the basis of those accounts.

Where a completion accounts consideration structure is used, it is common to see a portion of the purchase price placed into escrow with a third-party escrow agent at closing as security for any post-closing payment that is required to be made by the seller as a result of the completion accounts adjustment.

Where an acquisition is made by a PE buyer in a "primary" deal (i.e. not from a PE seller), it is not unusual for a portion of the consideration to paid on a deferred basis, most commonly pursuant to an "earn-out" where the performance or growth of the acquired business will be measured against an objective criteria (usually a financial-based criteria during a defined time period) in order to determine what portion of the deferred consideration will be payable.

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

A PE seller will in most cases only provide "fundamental" warranties, being those regarding title to shares, capacity and authority. A PE seller will only provide business and operational warranties as to the target in limited circumstances and this is becoming rarer under the current market conditions.

Business and operational warranties are usually given by certain members of the senior management team of the target and will be given subject to relatively low liability caps (dependent on the deal proceeds received by management warrantors). These business and operational warranties will be contained in a separate management warranty deed and a fulsome disclosure process will be carried out to disclose against these warranties. These management warranties are more and more being seen as a tool to elicit accurate and fulsome disclosures regarding the target from the individuals who run the business of the target on a day-to-day basis. Given the low liability caps that generally apply to these warranties from management, a buyer will typically seek to obtain coverage for these warranties above the liability cap of the management warrantors by putting in place W&I insurance.

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

PE sellers will customarily provide certain pre-completion covenants and undertakings to a buyer, including: (i) a no-leakage covenant (in the case of a "locked-box" deal) where the buyer will be able to recover any leakage on a £-for-£ basis; (ii) covenants to provide assistance with, and if relevant, obtain regulatory clearances or satisfaction of other conditions; (iii) operational covenants as to how the business of the target may or may not be run in the pre-completion period; and (iv) certain limited covenants regarding the provision of information during the pre-completion period. Indemnification for specific risks is relatively uncommon for PE sellers to give, although it is sometimes seen where the PE seller and the buyer have a materially different view on the likelihood of a specific risk crystallising. More commonly, PE sellers are pushing buyers to "price in" these types of risks.

PE sellers are unlikely to give non-compete covenants, whereas it is common for exiting members of management or founders to give a full suite of restrictive covenants lasting throughout pre- and post-completion.

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

W&I insurance as a product is continuing to increase in popularity with buyers and sellers seeing the benefit of the product in "bridging the divide" between sellers (including management warrantors where relevant) and buyers in terms of residual post-closing liability. It is relatively standard in a competitive sell-side process for the seller to insist on use of W&I insurance by the buyer to cover the business and operational warranties that are provided by management. In some transactions, more aggressive sellers will also insist that the buyer obtains coverage for the fundamental warranties as to title to shares, capacity and authority up to the W&I insurance policy liability cap with the seller standing behind the balance of liability above the W&I insurance policy liability cap for the fundamental warranties.

Excesses and policy limitations and resulting pricing will differ based upon, and be impacted by, insurer, industry sector, jurisdictions of operation, quality of diligence, thoroughness of disclosure process and seller/management warrantor liability cap. With respect to business and operational warranties, the usual buyer recourse profile will be first against the seller/management warrantor up to the relevant excess (which will usually match the attachment point under the W&I insurance policy) and then against the W&I policy up to the relevant liability cap of the policy. The *de minimis* financial limitation that applies to claims under the business and operational warranties will commonly match in the transaction documentation and the W&I policy and is often driven by the W&I insurer. It is unusual for sellers/management warrantors to stand behind any additional liability above the relevant W&I policy liability cap, except where the fundamental warranties are being insured. In terms of the W&I policy liability caps being obtained in buy-side W&I policies, these range from between 5% and 100% of the enterprise value, with the most common range being between 15% and 40% of the enterprise value of the target.

More recently, there has been a trend towards lower seller/management warrantor excesses (i.e. liability caps in the transaction documentation) and an excess as low as £1 can be obtained where the business of the target is considered particularly "clean" and insurable. Where management warrantors are required to have material "skin in the game" under the management warranty deed, it is common for the relevant PE seller to offset this potential liability by way of escrow or retention to fund claims against management or by way of transaction bonuses payable on closing.

The major downside of W&I insurance is that there are certain exclusions, both general to all W&I insurance policies (i.e. secondary tax liabilities, anti-bribery and corruption) and transaction-specific to address gaps in the scope of diligence carried out or particular risks relevant to the industry in which the target operates. In the current market, sellers/management warrantors do not customarily stand behind warranty claims that fall within the ambit of such policy exclusions and instead this potential risk is borne by buyers and ultimately priced in.

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

Given that a PE seller's warranties will generally be limited to certain fundamental warranties as to title, capacity and authority, a PE seller's liability for these warranties is typically capped at the purchase price. Such fundamental warranties are not usually subject to additional financial limitations, such as a *de minimis* or threshold (i.e. excess). The fundamental warranties are typically given subject to time limitations of between three and seven years from closing.

Seller liability under the "no-leakage" covenant is usually uncapped and recoverable from the seller on the basis of leakage received or benefitted from, given that compliance with such a covenant is entirely within the control of the seller.

The liability of management warrantors for the business and operational warranties can be subject to various negotiated limitations, including: (i) warranties are usually given on a several basis only (i.e. each manager is only liable for its proportionate share of liability for any claim and/or its own breach); (ii) warranties can be given subject to actual awareness of the relevant management warrantor group; (iii) financial limitations as to (A) aggregate liability cap, (B) threshold, below which a warranty claim cannot be made (which can be on a "tipping" basis or "excess only" basis), and (C) *de minimis*, being the minimum quantum of liability that a warranty claim must meet in order to count towards the threshold; and (iv) time limitations within which claims under the warranties must be made, which range from between one year and three years for claims under the non-tax warranties and between four and seven years for claims under the tax warranties.

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

Given PE sellers generally only provide fundamental warranties as to title, capacity and authority, no security (financial or otherwise) is provided as the risk of a breach of these warranties should be very low. With respect to the no-leakage covenant provided in "locked-box" deals, it is uncommon for PE sellers to provide any security in relation to this risk as most buyers take the view that the reputational damage caused to a PE seller for a large leakage claim is a material deterrent to the PE sponsor engaging in activity that constitutes leakage. This position also aligns with the PE industry focus of returning proceeds to LPs/investors as soon as possible post-closing in order to maximise economic return metrics.

This position is clearly at odds with the general desire of buyers (both PE and non-PE) to obtain meaningful post-closing recourse with respect to warranties and covenants. Given the fact the current market is largely a seller's market, this had been a major driving factor in the rise of W&I insurance.

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

The market has evolved such that buyers will typically provide (i) an equity commitment letter ("ECL") in respect of the equity portion of their consideration, and (ii) "certain funds" committed debt papers ("Debt Commitment Papers") from a lender in respect of the debt portion of their consideration. In some circumstances, a buyer may provide an ECL in respect of the entire consideration and address the debt portion privately behind the scenes, although we see this less frequently in mid- and upper-market transactions.

The ECL will come from the buyer's PE fund itself, will be addressed to the buyer's Bidco, and may sometimes also be addressed to the seller. Such ECL will generally include covenants that the fund will (i) call required capital from its investors to fund the equity portion of the purchase price, and (ii) fund Bidco with the equity capital required to fund such relevant portion of the purchase price (or a seller's damages claim for failure to complete), which is subject only to the satisfaction of the conditions in the share purchase agreement. This ECL will customarily also include certain commitments from the PE sponsor aimed at ensuring Bidco draws down the requisite funds under the Debt Commitment Papers in order to complete the transaction.

The seller will usually be able to enforce the ECL commitment directly, or on behalf of Bidco, against the PE fund to the extent the transaction becomes unconditional and the buyer fails to comply with its obligations to pay the consideration under the transaction documentation. If the banks under the Debt Commitment Papers do not fund when they are legally required to, the PE buyer may be required to take certain steps to enforce against the banks and/or use reasonable endeavours to obtain alternative debt financing.

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

Reverse break fees are uncommon in the current UK PE market largely as a result of the fact that in the UK market it is not typical for a buyer to have a walk-away right between signing and closing, e.g. in the event of a "material adverse change" in the business or if the debt financing is not obtained (as opposed to the U.S., where both of these rights for buyers are more common and hence so is the use of reverse break fees).

## 7 Transaction Terms: IPOs

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

Exiting from an investment by way of an 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. In addition, any failures of an IPO are inevitably more "public" than the failure of a private disposal process. This can add wider reputational risk to a disposal.
- Incomplete exit: When an IPO is successful, that still does not generally enable an immediate full exit for the PE fund on day one of the IPO. It is typical that the PE sponsor would be subject to a "lock-in" period for at least six months following a successful IPO, during which time it will not be able to sell its shares in the listed company. Following the end of the "lock-in" period, it is likely that an "orderly market" period (perhaps of up to 12 months) will follow, during which the sale of the PE sponsor's stake in the business can only be sold in a staggered way, to avoid affecting the price of the target company's shares too significantly as a result of the disposal.
- Unclean exit: The reluctance of a PE sponsor to provide any ongoing W&I protections in relation to the sale of their target companies is well-understood. However, in relation to any IPO of a PE-invested business, the PE sponsor will find it increasingly challenging to resist providing an investment bank underwriting the IPO with at least some warranties in relation to its ownership of the shares in the company being floated, in relation to itself and, in certain circumstances, in relation to an underlying business.

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

As mentioned in the answer to question 7.1 above, the duration of the "lock-in" provided by the PE sponsor will vary from transaction to transaction but, typically, a period of at least six months following an IPO will apply. This means that no actual "exit" (in terms of realising value from the investment) will have been effected by the PE sponsor at the completion of the IPO; but only once the lock-up period has expired. In the meantime, the PE sponsor remains exposed to market risk for the duration of the "lock-in" period and, to a lesser extent, during the orderly market disposal period.

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

The year 2021 saw record breaking exit value generated in the UK, and investors remain largely bullish on the deal activity for 2022. Both market volatility (due to the war in Ukraine and other geopolitical, financial and supply chain issues) and liquidity (across debt, public equity and PE markets) remain high and have sustained strong valuations, despite risks of inflation, and rising interest rates. It is not uncommon to run a dual-track exit process, though a greater number of deals are concluded by way of bilateral or auction-driven private sales processes, as opposed to successful IPOs. This is reflective both of market conditions and also a general preference by funds to conclude private deals where possible, in order to avoid some of the negative aspects of 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.

### 7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?

Special purpose acquisition company ("SPAC") transactions, compared with traditional IPOs, offer a potentially speedier exit option for PE sellers. In addition, as SPACs are required to complete an acquisition within a stated period (typically 18–24 months), PE firms may have helpful pricing leverage in negotiating a deal with a SPAC that is nearing the end of its life cycle. Despite these advantages, SPAC transactions are relatively rare for PE sellers in the UK – this form of exit has been more commonly seen in the U.S. market. With listing activity in the UK in the first half of 2022 seeing a material slow down compared to 2020 and 2021, and general market sentiment on SPAC performance, SPAC transactions are even less likely to be used as an exit route than would have been the case in 2020 and 2021. Some of the challenges when considering a SPAC transaction include substantial disclosure to the market, which can be a time-consuming exercise and requirements for the portfolio company will also need to be prepared for life as a listed company, which may also be time consuming and expensive to implement.

## 8 Financing

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

Traditional bank-led leveraged loan financing remains the most common source of debt finance used to fund both mid-market and large PE transactions in the UK.

However, in recent years, there has been increasing competition between traditional bank lenders and non-bank (or "alternative") lenders for mid-market PE transactions, with funding increasingly being sought from alternative sources such as direct lending funds and other institutional investors. Participants in mid-market transactions have also increasingly looked to implement "unitranche" financing structures, pursuant to which traditional senior and junior debt tranches are replaced by a single tranche term facility carrying a single, blended rate of interest, usually on a floating rate. Other debt instruments, such as PIK or convertible debt, remains a small portion of the overall financing provided by third-party lenders.

For larger PE transactions, leveraged loans are often structured as a term loan B (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.

Aside from leveraged loan financing, high-yield bond financing remains an important source of funds and is commonly (albeit subject to fluctuating availability in the market) used alongside traditional senior secured bank loans.

A key theme in the UK leveraged finance market in recent years – and a function of the increased appetite of institutional investors (who traditionally invested in high-yield bonds) for leveraged loans – has been the convergence of the terms of English law leveraged loans with both high-yield bonds and U.S. leveraged loans. This has led to a general loosening of covenants in English law leveraged loans, with the market becoming more accepting of "covenant-loose" structures (that is, where the relevant loan agreement contains only a single ongoing or maintenance financial covenant, usually a leverage ratio) and, for stronger borrowers, "covenant-lite" structures (that is, where the loan agreement contains no maintenance financial covenants or only a springing leverage covenant for the benefit of the revolving creditors).

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

The UK is, generally speaking, an investor-friendly jurisdiction and there are no particular legal requirements or restrictions that would affect the choice or structure of debt financing of PE transactions in the UK. That said, practical deal concerns play an obviously important role in dictating the ultimate financing structure. For example, some PE funds have valued the lighter disclosure requirements of a leveraged bank loan as compared to a high-yield bond issuance (which requires the preparation of, amongst other things, a detailed offering memorandum). Further, in an acquisition context, another advantage of a loan (compared to a high-yield bond issuance) is that loans can typically be documented and executed on a much shorter timetable that is more aligned with the timing constraints of the acquisition itself. With its successful execution dependent on ever-fluctuating market conditions and increased disclosure requirements, a high-yield bond issuance, on the other hand, must typically either be bridged by a loan or funded into an escrow arrangement if being used to finance an acquisition.

Aside from such practical concerns, market participants should be aware of, and ensure compliance with, any industry-specific laws and regulations, as well as the broader regulatory regime affecting PE transactions.

For example, in the current sensitive political and regulatory climate, market participants need to be especially careful with regard to compliance with anti-bribery, corruption and sanctions laws. Aside from local laws, borrowers and sponsors should also be aware of the expansive nature and potential extraterritorial reach of such laws and regulations in the U.S., which can necessitate compliance by many non-U.S. entities (or entities that have only limited U.S. ties).

In the context of buyout transactions of public (as opposed to private) companies in the UK involving debt finance, a key issue will be to ensure compliance with the "certain funds" and cash confirmation requirements of the UK Takeover Code. These principles require that a bidder have the funds and resources in place on a certain funds basis to finance a proposed acquisition, prior to the public announcement of any bid (and the bidder's financial advisor must confirm the availability of such funds). In practical terms, this means that the bidder and its lenders will need to finalise and have executed the required loan documentation (and satisfy, subject to limited exceptions, the conditions precedent to the loan) at the bid stage.

The "certain funds" concept has also increasingly permeated and become a feature of private buyout transactions. Although not a legal requirement in this context, in practical terms this means that lenders will be required to confirm upfront the satisfaction of all of their financing conditions and agree to disapply loan drawstop events (other than certain limited exceptions) until after completion of the acquisition.

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

The recent trends were, until the war in Ukraine, mainly in favour of the borrower/sponsor side. We are seeing ever more flexibility in the additional debt baskets and in the permitted payments baskets too. There are one or two areas where the lenders have pushed back, however. For example, there is now usually a cap on the amounts that can be added to EBITDA by way of future synergies on an acquisition or group initiative. As a general comment, it is fair to say that the unitranche lenders are a little more conservative than bank lenders, perhaps reflecting the fact that they are more likely to hold the debt rather than to syndicate it away. As of early 2022, deal-flow is back where it was immediately prior to COVID, but the war in Ukraine has caused the bond markets to be closed as of now (July 2022). The banking markets are still open but somewhat constricted. The private debt markets seem still to be fully performing.

## 9 Tax Matters

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

At a high level, the primary tax focus is to establish a tax-efficient structure and, in particular, to mitigate tax leakage on payment flows from the underlying portfolio companies through the acquisition structure to investors.

From an investor perspective, withholding tax is often a material factor. However, since the UK applies no withholding to dividends or capital gains, withholding tax concerns in UK transactions tend to focus on interest and the ability to reduce the 20% rate of interest withholding through treaty relief or otherwise (which can be relevant to both external and investor-related debt).

Achieving the maximum deductibility of interest expense on financing remains an important area. In addition to long-standing restrictions on the deductibility of interest (such as under the thin capitalisation rules), relatively recently introduced interest barrier rules (which generally restrict interest deductions to 30% of EBITDA) and increasingly complex anti-hybrid rules provide further limitations, particularly where U.S. investors are concerned.

From a management perspective, the key objective is to minimise income tax on acquisition of shares and to achieve capital gains tax treatment on an exit (see questions 9.2 and 9.3 below).

UK transactions tend to utilise UK-incorporated and -resident companies in the acquisition structure, although non-UK incorporated but UK tax-resident companies are sometimes preferred for stamp duty efficiency.

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

Although favourable tax treatment for carried interest has become more difficult to achieve, capital gains tax remains available on carried interest returns in certain circumstances (at a 28% special rate for carried interest compared with the normal 20%). Management will look to ensure that carried interest is not treated as income for tax purposes under the "disguised investment management fee" ("DIMF") or income-based carried interest rules.

For equity investment/co-investment, senior management may be able to claim business asset disposal relief (formerly entrepreneurs' relief) (delivering a 10% rate of capital gains tax on sale) provided certain conditions are satisfied. In particular, to be eligible, an executive must hold at least 5% of the ordinary share capital and corresponding economic and voting rights for at least two years. With effect from 11 March 2020, a lifetime allowance of £1 million of gains is eligible for business asset disposal relief (a significant reduction from the £10 million of lifetime gains eligible for relief prior to such date).

Growth shares and deferred/vesting arrangements remain relevant in the UK and are commonly used as a means of delivering capital gains tax treatment on a future sale with a minimal income tax charge on acquisition.

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

Management will generally be keen to ensure that tax is deferred until any disposal proceeds are received and will want to maximise the availability of business asset disposal relief (although this will be less of a priority following the significant reduction in the lifetime allowance noted in question 9.2 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 required from HM Revenue & Customs ("HMRC") in connection with any tax-neutral rollover and should be factored into the transaction timing.

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

As is the case in most other jurisdictions, the UK tax rules have changed significantly in recent years in response to the OECD's Base Erosion and Profit Shifting ("BEPS") project. Measures impacting the PE industry include:

(a) The anti-hybrid rules that potentially disallow deductions for interest and other expenses in structures involving hybrid entities or instruments. The rules are commonly a cause of uncertainty in transactions involving U.S. investors where check-the-box elections have been made through the acquisition structure. This measure, together with (b) below, has led to the increasing use of preference shares rather than debt as a source of investor finance.

(b) The interest barrier rules (see question 9.1 above).

(c) The changes to the availability of double tax treaty relief as a consequence of the adoption of the OECD's multi-lateral instrument ("MLI"), 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. Following Brexit, the UK has largely stepped away from the mandatory disclosure rules introduced by the sixth amendment to the EU Directive on Administrative Cooperation ("DAC6") and proposes to introduce new rules in 2021, in accordance with the OECD's Mandatory Disclosure Rules.

On a domestic level, changes to the qualifying conditions for business asset disposal relief and a reduction in the available lifetime allowance from £10 million to £1 million have had a significant impact on many management teams.

## 10 Legal and Regulatory Matters

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

As outlined in the previous answers to the questions in this chapter, a range of UK and European laws affect PE investors and transactions. Among the most important of these is the Companies Act 2006 (which provides the basic framework of company law in England), the Financial Services and Markets Act 2000 (providing the basic framework of law relating to financial services in the UK), the Bribery Act 2010 (legislation aimed at prohibiting bribery and corruption by UK businesses and individuals worldwide), GDPR (which governs the transmission and collection of data in Europe) and the Takeover Code (referred to above). The National Security and Investment Act ("NSI") will enter into force later this year (2021) and extend the Government's powers to scrutinise and intervene in investments to protect national security. Although the UK chose not to adopt the EU Sustainable Finance Disclosure Regulation or the Taxonomy Regulation following Brexit, ESG matters remain high on the legislative agenda and the UK's evolving ESG regulations will affect both the operation of and reporting by PE investments.

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

PE funds (like other funds) that are managed from or marketed within EU Member States will generally be subject to some, or all, of the rules of the Alternative Investment Fund Managers Directive ("AIFMD") (an EU directive that looks to place hedge funds, PE and any other alternative investment firms into a regulated framework, in order to monitor and regulate their activity). All investors, including PE funds, could be subject to UK national security screening under the National Security and Investment Act, which entered into force earlier this year and 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.

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

Especially given that when buying assets from other PE sponsors they may not benefit from substantive warranty protection as to the condition of the business being sold to them, PE sponsors typically require detailed legal due diligence processes to be undertaken on the assets they are considering buying. These investigations will review most legal and business aspects of the target, including (but not limited to) investigations into title, assets, material contracts, ESG, intellectual property, litigation, real estate, and compliance. These investigations tend to be conducted on an issues-focused "red-flag" basis, and to be governed by materiality thresholds aligned to the size of the deal in question.

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

Anti-bribery legislation has further increased the focus of PE sponsors on the day-to-day business activities of the targets they are acquiring, and their sensitivities to various business practices and corporate conduct. This trend (driven, for instance, by the Bribery Act 2010 in the UK), has impacted the thoroughness of due diligence investigations, the day-to-day governance rights insisted upon by PE sponsors and, in some cases, the abandonment of proposed transactions due to insurmountable bribery or corruption issues in the relevant targets. In addition, the W&I insurance policies that are very often placed in connection with PE transactions generally exclude bribery and corruption from their cover.

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

In general, under English law, a shareholder is not liable for the underlying activities/liabilities of the company to which the shares relate. There are only very specific instances where a PE sponsor may be held liable for its portfolio company. One such example (with reference to the answer to question 10.4 above), is that a PE sponsor could incur liability under the Bribery Act 2010 by failing to implement adequate procedures for its portfolio company, and potentially under the UK Proceeds of Crime Act 2002 (the relevant "proceeds" of the crime of the bribery concerned being the investment proceeds enjoyed by the PE sponsor from the investee company).

## 11 Other Useful Facts

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

The UK remains a premier place in the world for investment by PE sponsors. A degree of uncertainty accompanied the UK's departure from the European Union on 31 January 2020. However, PE investments and exits have continued apace in 2021 and the UK's legal divergence from the European Union has proven gradual. The year 2021 saw several government initiatives intended to promote investment and job creation in the UK, such as the proposed creation of up to 10 freeports in locations around the UK. Aside from Brexit, many other factors remain that can influence investments by PE sponsors in the UK, and there is not sufficient room to cover them all here.

Topics of particular prominence in the UK at the time of writing are the ongoing impacts of the COVID-19 pandemic (addressed elsewhere in this chapter) and also the NSI, which will subject investment in industries thought to be of strategic significance (e.g. defence, life sciences and healthcare) to mandatory screening. This legislation is a response to concerns around the maintenance of national independence in certain areas, influenced by greater geopolitical uncertainties. These concerns are leading to a proliferation of national security regimes around the world.

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## 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 surged to record-setting levels in 2021, with both deal volume and deal values reaching unprecedented highs. Performance in 2021 was fueled by continued access to significant levels of dry powder, robust fundraising, easy access to debt at attractive rates and strong economic headwinds. Deal activity in the first half of 2022 has been tepid in comparison to 2021. Macroeconomic and geopolitical factors have created a more challenging environment for M&A and injected uncertainty into the outlook for 2022. Fundraising activity has continued in the first half of 2022, but at lower levels than the same period in 2021, and the market is crowded. A significant number of PE firms have been raising capital and competing for investments from large institutional allocators, many of whom committed their entire allocation for 2022 early in the year.

The frothy, competitive deal environment that characterized the past several years 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. The changing landscape in 2022 is slowing traditional PE investing and is expected to increase hold periods, but opportunities remain for take-privates, co-investments and opportunistic transactions, and continuation funds and GP-led secondaries are on the rise. 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?**

Over the last few years, 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 at a record high, parties are now faced with a less attractive environment for deal-making, with high inflation, rising interest rates and market volatility 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 war in Ukraine, supply chain disruptions, labor shortages and exploding energy prices have also had an impact. These factors are beginning to shift 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 has also 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.

**1.3 Have you observed any long-term effects for private equity in your jurisdiction as a result of the COVID-19 pandemic? If there has been government intervention in the economy, how has that influenced private equity activity?**

COVID-19 has not had significant long-term effects on the U.S. PE industry. However, one noteworthy trend is that parties have developed an increased level of comfort with conducting processes in a virtual or partially virtual setting, including fundraising, and this trend is expected to continue.

The U.S. government intervened in the economy in response to the COVID-19 pandemic in a number of ways, including with loan programs targeted at small businesses, such as Paycheck Protection Program ("PPP") loans, payroll tax deferrals and payroll tax credits under the CARES Act, and temporary modifications of certain aspects of the Tax Cut and Jobs Act of 2017. Stimulus was not aimed at PE, although PE funds and their portfolio companies were able to take advantage of certain benefits. At this point, few PPP loans remain outstanding, and any remaining deferred payroll taxes need to be paid by December 31, 2022. However, purchase agreements continue to address the risks associated with PPP loans and other stimulus obtained by target companies.

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

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 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. 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 management fees and returns on equity investments. Equity structuring varies depending on the PE sponsor involved, the portfolio company risk profile and the IRR sought. Equity most often 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. Rights often include negative covenants or veto rights over major business decisions, including material M&A transactions, affiliate transactions, indebtedness above certain thresholds, annual budgets and business plans, strategy, senior management hiring/firing and issuances of equity. In addition, PE sponsors will seek customary minority shareholder protections such as board and committee representation, information and inspection rights, tag-along and drag-along rights, registration rights and pre-emptive rights.

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

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

Management equity is typically subject to time- and/or performance-based vesting. Time-based awards vest in specified increments over several years (typically four to five years (in the Eastern United States) and sometimes less (in the Western United States)), subject to the holder's continued employment. Performance-based awards vest upon achieving performance goals, often based on the PE sponsor achieving a certain IRR or multiple on invested capital upon exit, 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.

### 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 contractual rights in favor of specified shareholders or classes of equity contained in a 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*. Although shareholder-level veto rights are sometimes employed, director-level veto rights are less common, as veto rights exercised by directors will generally be subject to their overriding fiduciary duty owed to the portfolio company, unless such duties have been validly disclaimed. See question 3.6.

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

Whether a PE investor owes duties to minority shareholders requires careful analysis and will depend upon several factors, including the legal form of the entity involved and its jurisdiction of formation.

Several jurisdictions hold that all shareholders in closely held companies owe fiduciary duties to each other and the company. In other jurisdictions, such as Delaware, only controlling shareholders owe fiduciary duties. In this context, the ability to exercise dominion and control over 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 to the shareholders by the controlling shareholder (and by the board of directors) 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 suggested that it would be open to permitting contractual waivers of the duty of loyalty by the shareholders themselves if done in clear and unambiguous language.

By contrast with the corporate statute, the Delaware statutes for alternative entities like LLCs and LPs allow the parties to 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 the company and its members or partners, provide greater flexibility than shareholders' agreements. Although governing law and submission to jurisdiction provisions may refer to the law of other states, or may apply the law of two or more states through bifurcation provisions, this approach is unusual and should be avoided, as it is unduly complicated and references to state laws outside the state of formation may render certain provisions unenforceable.

Non-competition and non-solicitation provisions in shareholders', LLC and LP agreements generally restrict management and non-PE co-investors, but not PE investors. These provisions are subject to the same enforceability limitations as when contained in other agreements. Enforceability will be governed by state law and must be evaluated on a case-by-case basis. The agreements must be constructed to protect the legitimate interests of the portfolio company and not violate public policy. Unreasonable temporal and/or geographic scope may render provisions unenforceable or subject to unilateral modification by courts. Other contractual provisions such as transfer restrictions, particularly for corporate entities, 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 nominating directors to private company boards, other than restrictions under applicable antitrust laws. For example, the Clayton Act generally prohibits a person from serving as an officer or director of two competing corporations. In 2019, the U.S. Department of Justice ("DOJ") expressed a desire to extend the scope of these restrictions on interlocking directorships to non-corporate entities and entities that appoint directors to competing entities as representatives or "deputies" of the same investor. If the Clayton Act is expanded in such a manner, PE funds may need to reevaluate their existing corporate governance arrangements with their portfolio companies. More recently in 2022, DOJ officials have said they are "ramping up efforts" to identify interlocking director violations and they are "committed to taking aggressive action" against PE investments in competitors that lead to interlocking boards.

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 new listing rules regarding board diversity and related disclosure.

Potential risks and liabilities exist for PE-sponsored directors nominated to boards. Directors appointed by PE investors should be aware that they owe fiduciary duties in their capacity as directors (subject to certain exceptions in the case of an LLC or LP where fiduciary duties of directors are permitted to be, and have been, expressly disclaimed). Directors of corporations cannot delegate their decision-making responsibility to or defer to the wishes of a controlling shareholder, including their PE sponsor. In addition, conflicts of interest may arise between the PE firm and the portfolio company. Directors should be aware that they owe a duty of loyalty to the company for the benefit of all of its shareholders (absent a waiver under the circumstances discussed above) and that conflicts of interest create exposure for breach of duty claims. 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 3.6. Under the duty of loyalty, directors must act in good faith and in a manner reasonably believed to be in the best interests of the portfolio company and may not engage in acts of self-dealing. In addition, directors appointed by PE firms who are also officers of the PE firm itself owe potentially conflicting fiduciary duties to PE fund investors. Directors need to be cognizant of these potential conflicts and seek the advice of counsel.

## 4 Transaction Terms: General

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

The timetable for a transaction generally depends on the due diligence process, negotiation of definitive documentation, and obtaining debt financing, third-party consents and regulatory approvals.

Antitrust clearance is the most common regulatory clearance faced. 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 (2022: US$101 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 2022.

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.

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.

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?

In recent 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 are commonly 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.

Although the current market for M&A has softened in comparison to 2021, which may result in some transaction terms becoming less seller-favorable over the coming months, many of these trends are expected to 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 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 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. 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.

### 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% 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 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 been expanded over the last few years to include COVID-specific exclusions and liabilities related to PPP loans.

Despite competition among R&W insurers, consistent with other insurance markets, pricing of R&W insurance policies has tightened, with premiums and broker fees commonly around 3–5% 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 more 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%) 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 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 often delivers its own equity commitment letter.

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

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

In the current market, closings are rarely, if ever, conditioned on the availability of a buyer's financing. In certain circumstances, PE buyers may accept the risk that they could be forced to close the transaction by funding the full purchase price with equity. However, buyers seeking to limit such exposure typically negotiate for a reverse break fee, which allows termination of the transaction in exchange for payment of a pre-determined fee if certain conditions are satisfied. Depending on the terms, reverse break fees may also be triggered under other circumstances, such as a failure to obtain HSR approval. Typical reverse break fees range from around 4–10% of the target's equity value, with an average of around 5–7%, and may be tiered based on different triggering events. Where triggered, reverse break fees typically serve as a seller's sole and exclusive remedy against a buyer.

Given that PE buyers typically have no assets prior to equity funding at closing, sellers commonly require PE sponsors to provide limited guarantees of reverse break fees.

## 7 Transaction Terms: IPOs

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

Exits through IPOs will often be at higher multiples and more readily apparent market prices than exits through third-party sale transactions. However, exits through IPOs are subject to volatile market conditions and present other significant considerations. IPOs accomplished through acquisitions by special purpose acquisition companies ("SPACs") (i.e., de-SPAC transactions) have decreased in popularity recently, given heightened regulatory scrutiny, performance of recent de-SPAC transactions, 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 reelection following the IPO. Absent submission of nominees by third-party stockholders through proxy contests, which are unusual in the United States, PE sponsors can ensure election of their nominees. As these favorable PE rights are unusual in U.S. public companies, the rights often expire when the sponsor's ownership falls below specified thresholds.

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

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

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

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

Depending on market conditions, PE sponsors may simultaneously pursue exit transactions through IPOs and private auction sales. Dual-track transactions 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 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.

### 7.4 Do private equity sellers seek potential mergers with SPAC entities as an alternative to an IPO exit? What are the potential market and legal challenges when considering a "de-SPAC" transaction?

While de-SPAC transactions can present a quicker, easier path to a public listing than a traditional IPO, the SPAC boom in the U.S. has cooled, and neither SPACs nor traditional IPOs are attractive alternatives to a private transaction in the current market. See question 7.3. Some of the challenges presented in a de-SPAC transaction are the same as would be present in a traditional IPO. The portfolio company will need financial statements that are audited in accordance with SEC and PCAOB standards and may need to build out its finance function in order to be able to comply with financial reporting requirements and implement necessary controls over financial reporting. De-SPAC transactions also depend on the presence of a robust PIPE market.

## 8 Financing

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

The most common sources of debt financing used to fund private equity transactions are bank loans and high-yield bonds. Bank loans can be provided by traditional banks or direct lending institutions and can be syndicated (typically when arranged by traditional banks) or non-syndicated (i.e., a single-lender or club deal with a smaller group of lenders, typically when provided by direct lending institutions). Private equity sponsors generally fund their acquisitions with bank loans and then look to obtain high-yield bonds or a combination of both as the size of the deal gets larger.

Direct lending institutions continue to be the key players in private equity transactions due to their competitive advantage over traditional banks, including an ability to take on higher leverage, unconstrained by the bank regulations, and provide faster execution of the deal and certainty of terms with no "market flex" risk. The notable difference in the recent market has been the size of the deals in which direct lending institutions are participating – direct lending institutions used to fund smaller, middle-market deals in prior years, but an increasing number of PE sponsors, including the so-called "mega funds," have been turning to direct lending institutions to fund their large-cap 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?

Traditional banks continue to be governed by capital requirement guidelines and regulations affecting highly leveraged loans, which have faced increasing criticism. Some of these regulations have been 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 lending institutions, as their role in the debt financing market has been ever increasing.

Stricter enforcement of sanctions has also been a key area of focus in the debt financing market since the wake of the Russian-Ukrainian war, which has resulted in a number of PE funds and their portfolio companies having to navigate ways to manage relationships and/or cut ties with Russian investors.

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

Due to the uncertainty caused by higher interest rates and inflation, the debt-financing market for PE transactions has slowed in the first half of 2022 from its peak activity level in 2021. However, private credit funds continue to actively raise capital, which translates into more funds to be deployed in PE transactions, and the level of add-on acquisitions by corporate borrowers and portfolio companies has remained high. Another recent trend has been the increasing number of amendments being executed in the debt-financing market to, among other things: (1) convert LIBOR loans into SOFR loans, as most bank or other lending institutions now require any new loans be made as SOFR loans as an internal policy matter; or (2) modify the EBITDA definition and/or the financial covenants as many corporate borrowers and portfolio companies continue to deal with the aftermath of the COVID-19 pandemic, such as decreased EBITDA or other liquidity issues resulting from labor shortages or supply chain issues.

## 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 – under the current tax regime – to benefit from reduced tax rates on long-term capital gains.

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

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

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

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

There have been a number of significant changes in recent years. Significant changes to the tax audit process have become effective, and significant tax reform enacted in 2017, commonly referred to as the Tax Cuts and Jobs Act, resulted in many material 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. In some cases, these new rules are temporary in nature and their continuing impact should therefore be reviewed on a case-by-case basis. It is possible that further legislation or other initiatives relating to COVID-19 matters could be enacted.

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

Careful consideration and attention should be given to developments in this area. Future tax legislation and other initiatives could result in additional meaningful changes to the U.S. income tax system.

## 10 Legal and Regulatory Matters

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

See question 1.3 for a discussion of certain government programs implemented in response to the COVID-19 pandemic. The Tax Cuts and Jobs Act was enacted in 2017 and, more recently, there have been legislative and other tax initiatives related to the COVID-19 pandemic. See section 9.

The Chair of the FTC and the Assistant Attorney General for DOJ's Antitrust Division have recently expressed strong 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 enactment of FIRRMA in August 2018, the implementation of related regulations that culminated in late 2020, and the dedication of increased resources 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.

The California Consumer Privacy Act of 2018 ("CCPA") represented a paradigm shift in U.S. privacy law. The California Privacy Rights Act, which aligns even more closely with the General Data Protection Regulation ("GDPR"), will replace the CCPA on January 1, 2023. Numerous other state-specific privacy laws will also take effect in 2023. This state-level activity, the Chair of the FTC's focus on tech and privacy practices, and the potential for a federal privacy law have created a complex legal 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 compliance programs.

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

There is enhanced scrutiny by CFIUS of transactions involving non-U.S. investors and U.S. businesses that operate in industries, or otherwise deal with technologies 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' 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 10.1.

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

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

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

PE buyers and counsel will evaluate the target's risk profile with respect to anti-bribery and anti-corruption legislation, including the Foreign Corrupt Practices Act ("FCPA"). The risk profile depends on, among other things, whether the target conducts foreign business and, if so, whether any of the business is conducted (i) in high-risk regions (e.g., China, India, Venezuela, Russia and other former Soviet countries and the Middle East), (ii) with foreign government customers, or (iii) in industries with increased risk for violations (e.g., defense, aerospace, energy and healthcare). Diligence will be conducted based on the risk profile 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 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.

**10.5 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?**

Fundamentally, under U.S. law, businesses operated as legally recognized entities are separate and distinct from owners.

Consequently, PE sponsors generally will not be liable for acts of portfolio companies. However, there are several theories under which "corporate" form will be disregarded. These include:

(i) Contractual liability arising to the extent the PE sponsor has agreed to guarantee or support the portfolio company.

(ii) Common law liability relating to: (a) veil piercing, alter ego and similar theories; (b) agency and breach of fiduciary duty; and (c) insolvency-related theories. Most often, this occurs when the corporate form has been misused to accomplish certain wrongful purposes or a court looks to achieve a certain equitable result under egregious circumstances.

(iii) Statutory control group liability relating to securities, employee benefit and labor laws, the FCPA and consolidated group rules under tax laws.

The two most common areas of concern relate to potential liabilities under U.S. environmental laws and employee benefit laws. The Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") can impose strict liability on owners and/or operators of a facility with respect to releases of hazardous substances at the facility owned or operated by the portfolio company. However, unless PE sponsors exercise actual and pervasive control of a portfolio company's facility by actually involving themselves in the portfolio company's daily operations at the facility or its environmental activities, they should not be exposed to liability as an operator of such facility. Parents also should not have indirect or derivative liability for the portfolio company's liability under CERCLA, unless there is a basis for veil piercing.

Under the Employee Retirement Income Security Act ("ERISA"), when a subsidiary employer terminates a qualified defined benefit pension plan, all members of the subsidiary control group become jointly liable. Control groups arise among affiliates upon "the ownership of stock possessing at least 80% of total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of stock of such corporation."

ERISA imposes joint and several liability on any person who, upon termination of a plan, is a contributing sponsor of the plan or a member of the person's controlled group. As a result, all affiliated companies (including the PE sponsor and other portfolio companies) may face liability when an inadequately funded plan terminates, provided that the 80% control test is satisfied.

## 11 Other Useful Facts

### 11.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

Contract law in the United States embraces the freedom to contract. Absent public policy limits, PE sponsors in U.S. transactions are generally able to negotiate and agree upon a wide variety of transaction terms in acquisition documents that satisfy their underlying goals.

Transaction parties should expect increased regulation in the United States. In particular, new regulations should be expected in the arenas of cybersecurity and protection of personal data (both at the federal and state level) that will affect both how diligence is conducted and how portfolio companies operate. See question 10.1. Tax continues 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 2022. See section 10.

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Dechert has been at the forefront of advising private equity firms for 35+ years. With more than 300 private equity 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 private equity lawyers advises private equity, private credit and other alternative asset managers on flexible solutions at every phase of the investment life cycle.

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