



# Private Equity

in 32 jurisdictions worldwide

# 2013

Contributing editor: Casey Cogut



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# United States

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## 1 Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction? What structures are commonly used in private equity investments and acquisitions?

US private equity transactions may involve the acquisition by a private equity sponsor of a controlling stake in a private or public company, which is typically structured as a stock purchase, asset purchase, merger, tender offer or leveraged recapitalisation. Private equity sponsors may also make minority investments in public or private companies, which typically involve the purchase of common stock, preferred stock, convertible debt or equity securities, warrants or a combination of such securities. Private equity transactions involving the acquisition of a private or public company are generally structured as leveraged buyouts (LBOs) in which a significant amount of the purchase price is paid with the proceeds of new debt; this debt is usually secured by assets of the target and serviced from the cash flows of the target. In acquisitions of a public company, a private equity sponsor may engage in a going-private transaction, which typically involves a one-step transaction via a merger or a two-step transaction involving a tender offer followed by a merger. As discussed in question 4, going-private transactions subject to rule 13e-3 of the US Securities Exchange Act of 1934 generally require significantly greater disclosure than other types of private equity transactions.

Private equity funds typically create a special purpose shell acquisition vehicle to effect an investment or acquisition, and commit to fund a specified amount of equity capital to the acquisition vehicle at the closing. Various considerations dictate the type and jurisdiction of organisation of the acquisition vehicle, including, among others, tax structuring issues, desired governance structure, number of equityholders, equityholders' (and the private equity sponsor's) exposure to liability by use of the applicable vehicle, general ease of administration and any required regulatory requirements.

## 2 Corporate governance rules

What are the implications of corporate governance rules for private equity transactions? Are there any advantages to going private in leveraged buyout or similar transactions? What are the effects of corporate governance rules on companies that, following a private equity transaction, remain or become public companies?

The Sarbanes-Oxley Act of 2002 and related Securities and Exchange Commission (SEC) and stock exchange rules raise a variety of issues relevant to private equity transactions, including those outlined below:

- if the target in a private equity transaction continues to have listed common equity, a majority of the target's board of directors, audit committee, nominating or corporate governance committee and compensation committee must meet stringent independence requirements;

- the New York Stock Exchange and Nasdaq Stock Market do not require 'controlled companies' (namely, companies in which more than 50 per cent of the voting power is held by an individual, group or another company) to maintain a majority of independent directors on the board or have a nominating or compensation committee comprised of independent directors; however, controlled companies are still required to maintain an audit committee comprised entirely of independent directors, and following implementation of reforms pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, a compensation committee will be required to meet enhanced independence standards, which have been proposed by the New York Stock Exchange and the Nasdaq Stock Market;
- in conducting due diligence on a public target, private equity sponsors must carefully review the target's internal financial controls, foreign corrupt practices and anti-bribery law compliance and prior public disclosures to evaluate any potential liability for past non-compliance and to avoid stepping into a situation in which significant remedial or preventive measures are required;
- if a private equity sponsor requires management of a public target to purchase equity of the target or a new entity formed in connection with the transaction, the sponsor should be aware that a public target is generally not permitted to make loans or arrange for the extension of credit to any directors or officers of the target to fund such purchases;
- if a sponsor intends to finance a transaction with publicly traded debt, the target must have an audit committee comprised entirely of independent directors and must comply with enhanced disclosure requirements (for example, disclosure of off-balance sheet arrangements); and
- if a private equity sponsor intends to exit an investment following an initial public offering of the target's stock, the exit strategy must take into account the time, expense, legal issues and accounting issues that may arise in connection with becoming a public company.

A number of public companies consider going-private transactions in the light of the stringent US corporate governance regime and scrutiny of accounting and executive compensation policies and practices. Companies that do not have publicly traded equity or debt securities are exempt from complying with the corporate governance rules in the Sarbanes-Oxley Act and related SEC and stock exchange rules. Some of the advantages of a going-private transaction include the reduction of expenses relating to compliance and audit costs, elimination of public disclosure requirements and decreased risks of liability for directors and management.

**3 Issues facing public company boards**

What are the issues facing boards of directors of public companies considering entering into a going-private or private equity transaction? What procedural safeguards (eg, special committees of independent directors), if any, do public companies use when considering transactions? What is the role of a special committee in such a transaction where senior management, members of the board or significant shareholders are participating or have an interest in the transaction?

When the board of directors (or any special committee thereof, as described below) reviews a going-private or private equity transaction proposal, the directors must satisfy their fiduciary duties, as would always be the case, and their actions must satisfy the applicable 'standard of review' under the law of the state of organisation of the target company, which may affect whether the directors could be personally liable in any lawsuit that challenges the transaction. Other preliminary issues to be considered by the board of directors of a public company in considering a going-private or private equity transaction proposal include various disclosure issues. Generally, the board of directors of the target company will be consulted by management before the target company discloses confidential information regarding itself to a prospective private equity investor pursuant to an appropriate confidentiality agreement, which may include 'standstill' provisions that prevent a sponsor and its affiliates from acquiring or making proposals to acquire any securities of the company without the board's prior consent. Note that, under US securities laws, a sponsor and its affiliates may be restricted from acquiring securities of a public company if the sponsor is in possession of material, non-public information with respect to such company. Also, as discussed in question 12, boards of directors must consider fraudulent conveyance issues presented by any proposed debt to be incurred by the company in connection with the private equity transaction.

A critical threshold determination to be made by a board of directors regarding its consideration of a going-private or private equity transaction proposal is whether the board should form a special committee of directors to consider and make decisions with respect to the proposed transaction. In Delaware (the leading US corporate jurisdiction), if persons affiliated with the parties making the going-private or private equity transaction proposal (including any significant shareholders participating in the transaction) or persons otherwise subject to a conflict of interest (including members of the board of directors or management of the target company participating in the transaction) with respect to the proposal comprise a majority of a corporation's board of directors, the 'entire fairness' standard will apply – which places the burden of proof on the board to show that the transaction was fair to the unaffiliated shareholders. To reach such determination, both the transaction process and the resulting transaction price must be found to be fair to the unaffiliated shareholders. In the event that a transaction may be subject to the entire fairness standard, a board of directors will typically form a special committee comprised entirely of disinterested directors to shift the burden of proof to any person who may legally challenge the transaction. Generally, best practices would result in the special committee being comprised solely of disinterested directors, having the right to engage its own financial adviser and legal counsel and being authorised to independently negotiate and evaluate the transaction as well as alternative courses of action, including pursuing other acquisition proposals or continuing to implement the target company's strategic plan as a stand-alone company.

**4 Disclosure issues**

Are there heightened disclosure issues in connection with going-private transactions or other private equity transactions?

Generally, going-private transactions and other private equity transactions are subject to the same disclosure requirements under the US securities laws that are applicable to other merger and acquisition transactions. However, certain going-private transactions are subject to rule 13e-3 of the US Securities Exchange Act of 1934, which mandates significantly greater disclosure than is ordinarily required by the federal proxy rules or tender offer rules. Generally, rule 13e-3 will apply only if the going-private transaction involves a purchase of equity securities, tender offer for equity securities or proxy solicitation related to certain transactions by the company or its affiliates (which includes directors, senior management and significant shareholders); and will result in a class of the company's equity securities being held by fewer than 300 persons or a class of the company's equity securities listed on a stock exchange to no longer be listed. The heightened disclosure requirements applicable to going-private transactions subject to rule 13e-3 include, among other items, statements by the target and other transaction participants as to the fairness of the transaction to disinterested shareholders, plans regarding the target company, alternative transaction proposals made to the target, disclosure regarding control persons (for example, information about directors and officers of private equity sponsors) and information regarding the funding of the proposed transaction. Also, the target company will need to publicly file or disclose any report, opinion or appraisal received from an outside party that is materially related to the transaction and any shareholder agreements, voting agreements and management equity agreements. If the going-private transaction (whether or not subject to rule 13e-3) is structured as a tender offer or transaction requiring the vote of the target company's shareholders (for example, a cash or stock merger), the subject company's shareholders will be required to receive a tender offer disclosure document or a proxy statement or prospectus containing disclosure that satisfies the applicable US tender offer rules, proxy rules or Securities Act requirements (these generally require disclosure of all material information relating to the offer or transaction). In addition, a target company board of directors effecting going-private transactions and other private equity transactions must still comply with any applicable state law requirements. For example, the Delaware courts are increasingly requiring additional disclosure in proxy and tender materials disseminated to shareholders with respect to prospective financial projections and forecasts which the target company shared with the private equity sponsor.

**5 Timing considerations**

What are the timing considerations for a going-private or other private equity transaction?

Timing considerations depend upon a variety of factors, including:

- the time necessary for the target's board or special committee to evaluate the transaction and any alternatives;
- the first date on which public disclosure of any proposal to acquire a public company target must be made if the proposal is being made by any person who has an existing schedule 13D or 13G filing;
- the time necessary for bank financing syndication, sales of debt securities, tender offers or consent solicitations relating to existing debt securities and any attendant delays;
- the time necessary for regulatory review, including requests for additional information from antitrust or other regulators;
- the magnitude of disclosure documents or other public filings and the extent of the SEC review;
- timing relating to solicitation of proxies, record dates and meeting dates in connection with a shareholder vote;

- timing relating to solicitation of tenders and other required time periods under the US tender offer rules (for example, tender offers must remain open for a minimum of 20 business days);
- the risks of significant litigation related to the transaction; and
- the time necessary to establish alternative investment vehicles and special purpose vehicles or to complete a restructuring of the target prior to closing.

#### 6 Purchase agreements

What purchase agreement provisions are specific to private equity transactions?

Historically, to the extent private equity sponsors required financing to complete a transaction, they negotiated for the right to condition their obligation to consummate the transaction upon their receipt of financing proceeds. In recent years, private equity buying groups have commonly agreed to buy companies without the benefit of a financing condition but, in such cases, typically have had the right to pay a 'reverse termination fee' to the seller as the sole remedy of the seller or target company against the buyer in the event that all of the conditions to closing have been satisfied (or are capable of being satisfied on the applicable closing date) but the buyer was unable to obtain the third-party debt-financing necessary to consummate the closing. Because the acquisition vehicle which is party to the transaction is almost always a shell entity (namely, not independently creditworthy), target companies typically require the acquisition vehicle's potential obligation to pay a reverse termination fee to be supported by a private equity fund limited guarantee or the receipt of a limited right to enforce the 'equity commitment letter' provided by the private equity fund to the acquisition vehicle, pursuant to which the fund commits to provide a specified amount of equity capital to the acquisition vehicle at closing. Most purchase agreements providing for a reverse termination fee include provisions that deem payment of such fee to be liquidated damages and otherwise cap the private equity fund's liability exposure to an amount equal to the reverse termination fee amount. Particularly in transactions involving third-party financing, private equity firms rarely agree to a full specific performance remedy that may be enforced against the private equity firm or special purpose acquisition vehicle used in the transaction.

In addition to the circumstances above, participants on the other side of a private equity transaction (whether sellers or buyers) will frequently require evidence of the creditworthiness of any special purpose acquisition vehicles used in the transaction to ensure they have a sufficient remedy in the event that the acquisition vehicle breaches its obligations under a purchase agreement or is required to satisfy an indemnification obligation. Participants in private equity transactions may attempt to negotiate guarantees, equity commitments or other support arrangements from a private equity sponsor, but most private equity sponsors resist indemnification, guarantee or other obligations that permit recourse directly against the private equity fund. However, as described above, in circumstances where a sponsor has agreed to pay a reverse termination fee, private equity funds frequently agree to provide a limited guarantee of the payment of the reverse termination fee or may provide the target company with a right to specifically enforce the equity commitment letter from the private equity fund to the extent of the reverse termination fee.

Both sellers and buyers in private equity transactions will generally seek to obtain fairly extensive representations, warranties and covenants relating to the private equity sponsor's equity and debt-financing commitments, the private equity sponsor's obligation to draw down on such financing and obtain any required alternative financing and the target company's obligation to assist with obtaining the financing and participating with any required marketing of the financing. These types of provisions, as well as various other financing-related provisions, are discussed further in question 11.

#### 7 Participation of target company management

How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues? Are there timing considerations of when a private equity sponsor should discuss management participation following the completion of a going-private transaction?

In a private equity transaction, the management of a target company may be offered the opportunity (or may be required) to purchase equity of the target company or the acquisition vehicle, which investment may be structured as a 'rollover' of such management's existing equity holdings. Whether and to what extent such investments are made may depend heavily on the type and amount of the management's historic compensation arrangements as well as the amount, if any, of cash payments management will receive in the going-private transaction, in respect of current equity and equity-based awards and payouts under deferred compensation and other plans. In connection with such investment, management typically also receives equity incentive awards (for example, stock options in a corporation or profits interests in a partnership). These equity awards generally become vested based upon continued employment, the achievement by the company of specified performance targets, the private equity sponsor achieving a particular return on its investment or a combination of the foregoing conditions. These agreements also typically provide for acceleration of vesting, repurchase or forfeiture of the equity incentive awards upon a termination of employment (the acceleration, repurchase or forfeiture depends upon the reason for the termination of employment) and often impose on the employees post-termination covenants not to compete with, or disparage, the company and not to solicit company employees or clients. All equity acquired by an employee will typically be subject to a shareholders' agreement, which customarily includes transfer restrictions, a repurchase right held by the company upon the employee's termination of employment for any reason (with the price varying based on the reason for the termination), drag-along and tag-along rights (which are described in question 13) and piggyback registration rights. Customary terms of shareholders' agreements are discussed in question 13.

Historically, one of the key concerns in private equity led going-private transactions has been continuity of management under the theory that private equity sponsors do not have any special expertise in operating the acquired business on a day-to-day basis. As such, the principal executive compensation issues in a private equity transaction relate to ensuring that equity-based and other compensation has been appropriately structured to provide an incentive to management to increase the company's value and remain with the company following the closing. To this end, primary questions involve whether management may rollover existing equity on a tax-free basis as part of their investment, the accounting and tax treatment (both for the company and management) of equity incentive awards and other compensation arrangements, and to what extent management can achieve liquidity under their investment and equity awards. It should also be noted that other issues, such as ongoing employee benefit protections (for example, post-termination welfare and pension benefits) and certain compensation arrangements (for example, base salary and annual cash bonus opportunities), will factor into any private equity transaction negotiation with management of the target company.

As described above, management participating in a private equity transaction may have several opportunities to earn significant value (both in the primary transaction and upon a successful future exit event). As a result, shareholders of a public company engaged in a going-private transaction are particularly concerned about conflicts between management's desire to complete a transaction or curry favour with the new private equity buyer, on the one hand, and shareholders' desire to maximise value in the transaction, on the other. In recent years, this issue has received significant attention, resulting in some boards of directors restricting their senior management from

participating in certain aspects of going-private transaction negotiations or discussing post-closing compensation arrangements with the private equity firm until after the price and material terms of the sale have been fully negotiated with the private equity firm and, in some cases, completed. In addition, in circumstances where a target company has negotiated the right to conduct a post-signing market check, or 'go-shop', or where an interloper has made an unsolicited acquisition proposal after signing that the board of directors of the target believes may result in a superior transaction for its shareholders as compared to the transaction entered into with the private equity firm, the target board may further restrict its senior management from participating in negotiations or discussions regarding post-closing compensation arrangements with all bidders, including the private equity firm, until the final winning bidder is agreed upon. Given the importance to private equity firms of the continuity of management and the structure of their equity and compensation-based incentives, which they often prefer finalising before entering into a going-private transaction, there is often a tension between the time when the board of directors of a target company will permit its senior management to negotiate such arrangements with a potential private equity buyer and when such a private equity buyer desires to have such arrangements agreed upon with such senior management. In addition, the SEC has required significant disclosure regarding management's conflicts of interests, including quantification of the amount to be earned by executives of the target company in the transaction.

#### 8 Tax issues

What are the basic tax issues involved in private equity transactions? Give details regarding the tax status of a target, deductibility of interest based on the form of financing and tax issues related to executive compensation. Can share acquisitions be classified as asset acquisitions for tax purposes?

Many US private equity funds are structured as limited partnerships or limited liability companies, which are generally treated as pass-through entities for tax purposes. Private equity transactions are frequently structured in such a manner to avoid or minimise the effect of 'double taxation' that results from investing directly into entities that are treated as corporations for tax purposes. However, such 'flow-through' structures could create US tax issues for tax-exempt and non-US limited partners of private equity funds. Generally, the substantial amount of debt involved in LBO transactions affords a target company significant interest expense deductions that offset taxable income. Careful attention must be paid to the terms of the acquisition debt to ensure that the interest is deductible under applicable US tax rules.

Private equity sponsors must also be aware of tax issues relating to management and employee compensation. Severance and consideration for equity holdings in connection with a change of control may be considered 'excess parachute payments', which are subject to a 20 per cent excise tax (in addition to ordinary income taxes) and which may not be deducted by the target. If an award granted is an 'incentive stock option', no income is realised by the recipient upon award or exercise of the option and no deduction is available to the company at such times. If the award granted is a non-qualified stock option, no income is recognised by the recipient at the time of the grant and no deduction is available to the company at such time. There are a number of limitations on incentive stock options; accordingly, non-qualified stock options are more typical. If a deferred compensation plan is 'non-qualified', all compensation deferred in a particular year and in prior years may be treated as taxable income in such taxable year to the extent that it is not subject to substantial risk of forfeiture.

In transactions where cash is paid for the shares of a target corporation, a seller and buyer may agree to treat the acquisition of stock of a corporation as an asset acquisition for US federal tax purposes by making a 338(h)(10) election. This election leads to a

'step-up' in the target's tax basis in its assets to the purchase price paid for such shares, resulting in additional depreciation/amortisation deductions and a tax shield to offset taxable income. A 'qualified stock purchase' of the target's stock (generally an acquisition by a corporation of at least 80 per cent of the target's issued and outstanding stock) must be made to make this election. Certain typical structures used in LBOs (for example, rollover of management equity to a newly formed vehicle that purchases target stock) must be carefully analysed to determine whether such structures will render the 338(h)(10) election impermissible.

#### 9 Principal accounting considerations

What are some of the principal accounting considerations for private equity transactions?

Similar to other business combinations, private equity transactions that involve the purchase of a controlling position in a company typically result in the use of the purchase method of accounting by the acquiring company. Under the purchase method, the acquirer is treated as having purchased the assets and assumed the liabilities of the target, which are then recorded at their current fair market values. The recording of the fair values could result in a write-up or a write-down as compared to the target company's carrying value or book value. The difference between purchase price paid and the identifiable assets acquired, net of the liabilities assumed (if any), would be attributed to goodwill. Identifiable assets include both tangible assets (for example, cash, accounts receivable, property plant and equipment) and intangible assets (for example, patents, trademarks and trade names, customer relationships, assembled work force).

In 2007, the US Financial Accounting Standards Board issued new M&A accounting standards intended to align US Generally Accepted Accounting Principles (GAAP) with the International Financial Reporting Standards (IFRS); these standards took effect in fiscal year 2009 for calendar year-end companies. The new standards impose more stringent criteria for determining the 'fair values' of assets and liabilities as of the acquisition date. Other key changes include new requirements in accounting for certain acquisition costs, contingent liabilities, contingent consideration such as 'earn-outs', in-process R&D and negative goodwill.

#### 10 Debt financing structures

What types of debt are used to finance going-private or private equity transactions? What issues are raised by existing indebtedness at a potential target of a private equity transaction? Are there any financial assistance, margin loan or other restrictions in your jurisdiction on the use of debt financing or granting of security interests?

LBOs generally involve senior bank debt, which is typically provided by commercial lending institutions in the form of a revolving credit facility and term loans (which are typically secured by the target's assets), and mezzanine debt, which is typically provided by private purchasers in the form of senior or senior-subordinated notes (or both), or by a public or rule 144A offering of high-yield bonds. In certain circumstances, mezzanine debt may be issued in conjunction with warrants to purchase equity in the target. Private equity transactions typically involve 'bridge-financing commitments' pursuant to which a commercial lending institution agrees to provide 'bridge' loans in the event that the mezzanine debt cannot be sold prior to the closing.

In transactions where target indebtedness is not expected to be retired at or before closing, the private equity sponsor must determine whether such indebtedness contains provisions that could restrict or prohibit the transaction, such as restrictions on changes of control, restrictions on subsidiary guarantees, restrictions on the granting of security interests in the assets of the target or its subsidiaries, restrictions on debt incurrences and guarantees and restrictions on dividends and distributions. A private equity sponsor must

also determine the manner in which and the cost at which existing indebtedness may be repaid or refinanced and evaluate the cost of the existing indebtedness compared with acquisition-related indebtedness, as well as the requirements of its financing sources relating to existing debt, capitalisation and other financial ratios applicable to the target. Private equity sponsors may require that certain debt of a target be repaid, redeemed, repurchased or amended as a condition to the closing of a transaction. In the case of public debt, private equity sponsors may require the target to effect a consent solicitation to eliminate certain covenants in the governing indenture (for example, financial information delivery requirements).

Generally, acquisitions of a US target are not subject to any statutory financial assistance restrictions or restrictions on granting security interests in the target company's assets, except as described herein or in the case of target companies in certain regulated industries. If a 'shell' company issues unsecured debt securities in a non-public offering with the purpose of acquiring the stock of a target corporation, such debt securities may be presumed to be indirectly secured by 'margin stock' (namely, any stock listed on a national securities exchange, any over-the-counter security approved by the SEC for trading in the national market system or any security appearing on the US Federal Reserve Board's list of over-the-counter margin stock and most mutual funds). If so, such debt would be subject to the US Federal Reserve Board's margin requirements and thus could not exceed 50 per cent of the value of the margin stock acquired. Private equity sponsors may avoid these requirements by utilising publicly offered debt or having the debt guaranteed by an operating company with substantial non-margin assets or cash flow.

#### 11. Debt and equity financing provisions

What provisions relating to debt and equity financing are typically found in a going-private transaction? What other documents set out the expected financing?

Purchase agreements in a going-private transaction typically include representations and warranties by the private equity sponsor regarding the equity-financing commitment of the private equity sponsor and, in the case of LBOs, the third-party debt-financing commitments obtained by the private equity sponsor at the time of entering into the purchase agreement. An equity commitment letter from the private equity sponsor (as described in question 6) as well as the debt-financing commitment letters obtained by the private equity sponsor from third-party lenders are customarily provided to the target company for its review prior to the execution of the purchase agreement. In US transactions, definitive debt-financing documentation is rarely agreed at signing; instead, the definitive debt-financing documentation is typically negotiated between signing and closing on the basis of the debt-financing commitment letters delivered by third-party debt-financing sources at signing. Purchase agreements in LBOs also contain covenants relating to obligations of the private equity sponsor to use a certain level of effort (often reasonable best efforts) to negotiate definitive debt-financing agreements and obtain financing, flexibility of the private equity sponsor to finance the purchase price from other sources and obligations of the target company to assist and cooperate in connection with the financing (for example, assist with the marketing efforts, participate in road shows, and assist in the preparation of financial statements and offering documents).

A purchase agreement may (or may not) condition the closing of a transaction on the receipt of financing proceeds by the private equity sponsor, as noted in question 6. If the closing is not conditioned on the receipt of financing proceeds, the purchase agreement would typically provide for a 'marketing period', during which the private equity sponsor will seek to raise the portion of its financing consisting of high-yield bonds (and, in certain cases, syndicated bank debt financing), and which begins after the private equity sponsor has received certain financial information about the target company necessary for it to market such high-yield bonds or syndicate such

bank debt. If the private equity sponsor has not obtained the proceeds of such financing by the end of the marketing period (or has failed to obtain such proceeds from a 'bridge' financing) and thus fails to close the transaction, the private equity sponsor may be required to pay a reverse termination fee – which often functions as a cap on the maximum amount of damages the target company (on behalf of itself or its shareholders) is permitted to seek from the private equity sponsor for its failure to close the transaction, as described in question 6.

#### 12. Fraudulent conveyance and other bankruptcy issues

Do private equity transactions involving leverage raise 'fraudulent conveyance' or other bankruptcy issues? How are these issues typically handled in a going-private transaction?

Generally, under applicable US state laws, a company may not transfer assets for less than fair consideration in the event that the company is insolvent or such asset transfer would make it insolvent. Thus, in highly leveraged transactions, there is some concern that when a target company issues or transfers its assets or equity to a private equity sponsor in exchange for the proceeds of acquisition financing, which is secured by the assets or equity of such target company, the lender's security interests in such assets or equity securities may be invalidated on a theory of fraudulent conveyance (namely, the target company has transferred its assets for inadequate value). It is common for a certificate as to the ongoing solvency of the continuing or surviving company to be obtained from such company's chief financial officer prior to closing a leveraged transaction. Purchase agreements in leveraged transactions may also include representations and warranties made by the private equity buyer as to the solvency of the company after giving effect to the proposed transaction.

Fraudulent conveyance issues should also be carefully considered by sellers in highly leveraged transactions. A board of directors considering a sale of the company should review the financial projections provided by management to a prospective buyer, and the indebtedness that the prospective buyer proposes the company incur in connection with the transaction, to evaluate any fraudulent conveyance risks. Directors of a target company must be particularly cautious in highly leveraged transactions in which the company has existing debt that will remain in place following the closing of the transaction. In Delaware (the leading US corporate jurisdiction), creditors of an insolvent corporation have standing to bring derivative actions on behalf of the corporation directly against its directors because, when a corporation is insolvent, creditors are the ultimate beneficiaries of the corporation's growth and increased value.

#### 13. Shareholders' agreements and shareholder rights

What are the key provisions in shareholders' agreements entered into in connection with minority investments or investments made by two or more private equity firms? Are there any statutory or other legal protections for minority shareholders?

Shareholders' agreements entered into in connection with minority investments or 'consortium' deals typically include the right of the minority investors to designate a certain number of directors and the right to approve (or veto) certain transactions (for example, change in control transactions, affiliate transactions, certain equity or debt issuances, dividends). Private equity sponsors may also seek pre-emptive rights to allow them to maintain the same percentage equity ownership after giving effect to a primary equity issuance by the target. In addition, shareholders' agreements frequently include transfer restrictions (which prohibit transfers of target securities for a particular time period and in excess of specified percentages, or both), tag-along rights (namely, the right of a shareholder to transfer securities to a person who is purchasing securities from another holder) and drag-along rights (namely, the right of a shareholder, typically the largest shareholder or a significant group of shareholders, to require other holders to transfer securities to a person who is purchasing securities

from such shareholder). Private equity sponsors typically seek other contractual rights with respect to receipt of financial and other information regarding the target company, access to the properties, books and records, and management of the target company, and also rights relating to their potential exit from the investment, such as demand and piggyback registration rights (which may include the right to force an initial public offering), put rights or mandatory redemption provisions. In certain circumstances, shareholders' agreements in private equity transactions may also contain 'corporate opportunity' covenants that either restrict (or in some cases, expressly permit) the ability of shareholders (including private equity sponsors) to compete with the subject company or make investments outside the subject company that may otherwise be a potential investment or acquisition opportunity for the subject company. Target companies or other large shareholders that are party to shareholders' agreements may also ask for a right of first offer or right of first refusal, which would require any shareholder seeking to transfer its shares to offer to sell such shares to the company or other shareholders.

In the US, minority shareholders often have limited protections outside of what may be contractually negotiated in a shareholders agreement. Generally, under applicable US state laws, the board of directors of corporations are subject to certain fiduciary duties in respect of the minority shareholders (for example, heightened scrutiny in controlling shareholder transactions with the target company, etc), and certain minimum voting requirements may apply for significant corporate actions, such as a merger. However, in most states, provisions in a target company's organisational documents may supersede the underlying statutory approval requirements. In addition, many private equity investments are held through non-corporate structures, which are subject to whatever fiduciary duties, if any, that are agreed in the applicable limited liability company agreement, partnership agreement or other similar governing arrangements. For private equity transactions structured as tender offers, US securities laws provide certain protections for minority shareholders (for example, the soliciting person is required to offer the same price to all holders of the applicable security and that the tender offer must be open for 20 business days, etc).

#### 14 Acquisitions of controlling stakes

Are there any requirements that may impact the ability of a private equity firm to acquire control of a public or private company?

Under applicable US state and federal law, there are no statutory requirements to make a mandatory takeover offer or maintain minimum capitalisation in connection with shareholders acquiring controlling stakes in public or private companies. However, under applicable US state law, the board of directors of public and private companies have fiduciary duties to their shareholders that they must be mindful of when selling a controlling stake in the company. In Delaware, for example, and in many other US states, a board of directors has a duty to obtain the highest value reasonably available for shareholders given the applicable circumstances in connection with a sale of control of the company. In certain states, the applicable law permits a board of directors to consider 'other constituencies' as well, and not simply focus on the impact that a sale of a controlling interest in the company will have on the shareholders of the company. Private equity sponsors must be mindful of these duties of target company boards of directors as they seek to negotiate and enter into an acquisition of a controlling stake of a target company, as it may result in the target company conducting a market check by implementing a pre-signing 'auction' or post-signing 'go-shop' process to seek out a higher bid for a controlling stake (or even the entire company) in order for the board of directors to feel comfortable that it has satisfied its fiduciary duties to the target company's shareholders. In addition, as discussed in question 17, US target companies in certain regulated industries may be subject to certain minimum

capitalisation requirements or other restrictions which may impede a private equity sponsor's ability to acquire the company.

#### 15 Exit strategies

What are the key limitations on the ability of a private equity firm to sell its stake in a portfolio company or conduct an IPO of a portfolio company? In connection with a sale of a portfolio company, how do private equity firms typically address any post-closing recourse for the benefit of a buyer? Does the answer change if a private equity firm sells a portfolio company to another private equity firm?

A private equity sponsor will generally seek to retain flexibility on its ability to sell its stake in an acquired company, which may include having the right to require an initial public offering and the right to drag along other investors in the event of a sale by the private equity sponsor of all or a significant portion of its investment in the company. The ability to achieve a tax-efficient exit and the ability to receive dividends and distributions in a tax-efficient manner will also be critical factors in determining the initial structuring of a transaction, including the use of acquisition financing or other special-purpose vehicles. Private equity sponsors must also consider the interests of company management in connection with any exit and must agree with management on any lock-up or continued transfer restrictions with respect to the equity of the target company held by management as well as ongoing management incentive programs which will continue following an IPO. In an exit (or partial exit) consummated pursuant to a portfolio company IPO, private equity sponsors typically remain significant shareholders in the company for some period of time following the IPO and, thus, continue to be subject to fiduciary duty considerations as well as securities laws, timing and market limitations with respect to post-IPO share sales and various requirements imposed by US stock exchanges with respect to certain types of related party transactions.

When private equity sponsors sell portfolio companies (including to other private equity sponsors), buyers may seek fairly extensive representations, warranties and covenants relating to the portfolio company and the private equity sponsor's ownership. Private equity sponsors often resist providing post-closing indemnification for breaches of such provisions. In limited situations in which a private equity firm agrees to indemnification following the closing of a portfolio company sale, sponsors often use a time and amount limited escrow arrangement as the sole recourse that the buyer may have against the private equity sponsor. Sponsor sellers and buyers have also addressed disagreements over indemnity through the purchase of transaction insurance (for example, representations and warranties insurance) to provide post-closing recourse to the buyer for breaches of representations or warranties. In such a case, the cost of purchasing the transaction insurance is typically negotiated by the buyer and seller as part of the purchase price negotiations.

#### 16 Portfolio company IPOs

What governance rights and other rights and restrictions typically included in a shareholders' agreement are permitted to survive an IPO? Are registration rights required for post-IPO sales of stock? What types of lock-up restrictions typically apply in connection with an IPO?

Private equity sponsors take a variety of approaches in connection with the rights they retain following a portfolio company IPO, depending on the stake retained by the private equity sponsor following the IPO. In many cases, the underwriters in the applicable IPO will push back on the private equity sponsor and seek to significantly limit the rights that a private equity sponsor will be permitted to retain following the IPO as it may diminish the marketability of the offering. For example, tag-along rights, drag-along rights, preemptive rights, and rights of first offer or rights of first refusal, in each case, for the benefit of the private equity sponsor frequently do not survive following an IPO. Except as described herein, US



regulations and US stock exchange rules do not generally legislate which governance rights may survive an IPO.

However, the private equity sponsor will often retain significant board of director nomination rights, registration rights and information rights following an IPO, and may retain various veto rights over significant corporate actions depending on the board control and stake held by the private equity sponsor. Under applicable US stock exchange rules, the board of directors of public companies are typically required to be comprised of a majority of 'independent' directors, but certain exceptions exist if a person or group would retain ownership of more than a majority of the voting power for the election of directors of the company, in which case, the company is referred to as a 'controlled company.' However, in order to improve the marketability of the offering and employ what is perceived to be favourable corporate governance practices, many private equity sponsors forgo the benefits of controlled company-status and employ a majority of independent directors and only retain minority representation on the board of directors following the IPO. In addition, private equity sponsors typically retain the right to cause the company to register and market sales of its securities and participate in piggyback registrations following an agreed-upon lock-up period (which is typically about six months following an IPO), subject to any applicable black-out rules and policies of the company and US securities laws.

#### 17 Target companies and industries

What types of companies or industries have typically been the targets of going-private transactions? Has there been any change in focus in recent years? Do industry-specific regulatory schemes limit the potential targets of private equity firms?

Private equity sponsors target companies as attractive acquisition candidates based on a variety of factors, including steady cash flow, strong asset base to serve as loan collateral or as the subject of future dispositions, strong management team, potential for expense reduction, undervalued equity and limited ongoing working capital requirements. Historically, typical targets have included manufacturing or production-based companies. In the past several years, private equity sponsors have been looking toward targets in the energy, financial, food, health care, media, real estate, retail, technology and telecom industries. In addition, certain private equity funds have a specified investment focus with respect to certain industries (for example, energy, retail, technology) or types of investments (for example, distressed debt).

Many regulated industries (for example, banking, energy, financial, gaming, insurance, media, telecom, transportation, utilities) must comply with special business combination legislation particular to those industries. Typically, approval of the relevant federal or state governing-agency is required before transactions in these industries may be completed. In certain situations, regulators may be especially concerned about the capitalisation and creditworthiness of the resulting business and the long- and short-term objectives of private equity owners. In addition, as a result of the extensive information requirements of many US regulatory bodies, significant personal and business financial information is often required to be submitted by the private equity sponsor and its executives. Furthermore, in certain industries in which non-US investments are restricted (for example, media, transportation), private equity sponsors may need to conduct an analysis of the non-US investors in their funds to determine whether specific look-through or other rules may result in the sponsor investment being deemed to be an investment by a non-US person. While none of these factors necessarily preclude private equity companies from entering into transactions with regulated entities, all of these factors increase the complexity of the transaction and need to be taken into account by any private equity sponsor considering making an investment in a regulated entity.

#### 18 Cross-border transactions

What are the issues unique to structuring and financing a cross-border going-private or private equity transaction?

The structure of a cross-border private equity transaction is frequently quite complicated, particularly given the use of leverage in most transactions, the typical pass-through tax status of a private equity fund and the existence of US tax-exempt and non-US investors in a private equity fund. Many non-US jurisdictions have minimum capitalisation requirements and financial assistance restrictions (which restrict the ability of a target company and its subsidiaries to 'upstream' security interests in their assets to acquisition financing providers), each of which limits a private equity sponsor's ability to use debt or special purpose vehicles in structuring a transaction. As noted in question 17, non-US investors may be restricted from making investments in certain regulated industries, and similarly, many non-US jurisdictions prohibit or restrict the level of investment by US or other foreign persons in specified industries or may require regulatory approvals in connection with acquisitions, dispositions or other changes to investments by foreign persons. In addition, if a private equity sponsor seeks to make an investment in a non-US company, local law or stock exchange restrictions may impede the private equity sponsor's ability to obtain voting, board representation or dividend rights in connection with its investment or effectively exercise pre-emptive rights, implement capital raises or obtain additional financing.

Furthermore, in a cross-border transaction, the private equity sponsor must determine the impact of local taxes, withholding taxes on dividends, distributions and interest payments and restrictions on its ability to repatriate earnings. Private equity sponsors must also analyse whether a particular target company or investment vehicle may be deemed to be a controlled foreign corporation or passive foreign investment company, both of which can give rise to adverse US tax consequences for investors in the private equity fund. Any of these issues may result in tax inefficiencies for investors or the violation of various covenants in a private equity fund's underlying documents that are for the benefit of its US tax-exempt or non-US investors.

#### 19 Club and group deals

What are the special considerations when more than one private equity firm (or one or more private equity firms and a strategic partner) is participating in a club or group deal?

Private equity sponsors may form a consortium or 'club' to pursue an acquisition or investment for a variety of reasons, including risk-sharing and the ability to pursue a larger acquisition or investment, since most fund partnership agreements limit the amount a fund may invest in a single portfolio company. In addition, private equity sponsors may form a consortium that includes one or more strategic partners who can provide operational or industry expertise and/or financial resources.

An initial consideration to be addressed in a club deal is the need for the confidentiality agreements often negotiated with the target company to allow each participant in the consortium to share confidential information regarding the target company with the other members of the consortium. Such confidentiality agreements may include language permitting each participant to share information with co-investors generally, may specifically identify each member of the consortium or may restrict a participant from approaching any potential co-investors (at least during an initial stage of a sale process) without obtaining the target company's prior consent. Such confidentiality agreements may also provide for an allocation of responsibility for any breach of the confidentiality agreements by a member of the consortium or such member's representatives and agents. Potential buyers' compliance with confidentiality agreements, including provisions limiting the ability of the potential buyer to share information

**Update and trends**

The volume of leveraged recapitalisations by issuers, including by private equity sponsor portfolio companies, increased in 2012. As of December 5th, issuers had obtained \$73.9 billion of dividend-related loans and high yield bonds in 2012 YTD, which represented an increase from 2011's all time high of \$56.9 billion. Not only did the total volume of such debt financing increase, but the attributable share of such debt financing by private equity sponsors and their portfolio companies also grew to \$60.6 billion, or 82 per cent, of such debt financing, as compared with \$34.4 billion, or 60.5 per cent, in 2011. As of 5 December 2012, approximately \$51.5 billion of the total \$73.9 billion of such debt financing had been used to pay dividends, as compared to \$35.6 billion in all of 2011. Private equity sponsor portfolio companies accounted for \$38.8 billion of such dividends, as compared to \$16.5 billion for all of 2011 (all data from Standard & Poor's Leveraged Commentary and Data).

Some of the factors driving this leveraged recapitalisation activity include the general availability of attractive debt financing, the potential for changes in US dividend tax rates at the end of 2012 and the general slowdown in the number of private equity sponsor portfolio company IPOs in 2012. In addition, according to Standard & Poor's Leveraged Commentary and Data, recapitalisation loans increased leverage on average from 3 times to 4.3 times EBITDA, which suggests that many of the issuers had significantly deleveraged prior to taking on increased debt loads, and the amount of leverage permitted by recapitalisation lenders was generally more conservative than LBO loans, likely because, in many cases, the loan proceeds were to be used to make equity distributions to the private equity sponsor shareholders for which lenders often require lower aggregate leverage levels.

with co-investors, has received significant attention in the US, with various litigation having been commenced with respect to these issues in the past few years.

Counsel to a consortium must ensure that the consortium agrees upon the proposed price and other material terms of the acquisition before any documentation is submitted to, or agreed with, the target company. In addition, counsel to a consortium will be required to ensure that the terms of any proposed financing, the obligations of each consortium member in connection with obtaining the financing and the conditions to each consortium member's obligation to fund its equity commitment have been agreed by each member of the consortium. It is not uncommon for consortium members to enter into an 'interim investors agreement' at the time of signing a definitive purchase agreement or submitting a binding bid letter that governs how the consortium will handle decisions and issues related to the target company and the acquisition that may arise following signing and prior to closing. An interim investors agreement may also set forth the key terms of a shareholders' agreement to be entered into by the consortium members related to post-closing governance and other matters with respect to the acquisition.

Each member of the consortium may have different investment horizons (particularly if a consortium includes one or more private equity sponsors and a strategic partner), targeted rates of return, tax or US Employee Retirement Income Security Act issues and structuring needs that must be addressed in a shareholders' agreement or other ancillary documentation relating to governance of the target company and the future exit of each consortium member from the transaction. Particularly in the case where a private equity sponsor is

partnering with a strategic buyer, the private equity sponsor may seek to obtain certain commitments from the strategic buyer (for example, non-competition covenants, no dispositions prior to an exit by the sponsor) and the strategic buyer may seek to limit the veto rights or liquidity rights (or both) of the private equity sponsor. As discussed in question 13, a shareholders' agreement would typically provide the consortium members with rights to designate directors, approval rights and veto rights and may include provisions relating to preemptive rights, tag-along and drag-along rights, transfer restrictions, future capital contributions, put rights, mandatory redemption provisions, rights of first offer or rights of first refusal, and restrictive covenants that limit the ability of each consortium member to engage in certain types of transactions outside of the target company. The various rights included in a shareholders' agreement are frequently allocated among consortium members on the basis of each member's percentage ownership of the target company following the consummation of the acquisition.

**20 Issues related to certainty of closing**

What are the key issues that arise between a seller and a private equity buyer related to certainty of closing? How are these issues typically resolved?

Target companies generally seek to obtain as much certainty to closing as possible, which includes limited conditions to the buyer's obligation to close the transaction and the ability to specifically enforce the obligation to close a transaction against the buyer. In private equity transactions without a financing condition, many private

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equity sponsors have made efforts to ensure that the conditions to their obligation to consummate the acquisition pursuant to the purchase agreement are substantially the same as the conditions of the lenders to fund third-party debt financing to the private equity sponsor's shell acquisition vehicle or are otherwise fully within the private equity sponsor's control. In this regard, there have been some transactions in recent years in which the purchase agreement included certain financial performance or other specific conditions related to the target company (for example, minimum amount of EBITDA, minimum credit rating or cash position, maximum debt to EBITDA ratio) that correspond to specific conditions contained in the third-party debt financing commitments.

Private equity sponsors have typically resisted a specific performance remedy of the seller in acquisition agreements. Private equity sponsors often use third-party debt financing in acquisitions and do not want to be placed in a position where they can be obligated to close a transaction when such third-party debt financing is unavailable and the ability to obtain alternative financing is uncertain. In addition to the fact that the transaction would likely no longer be consistent with the private equity sponsor's financial modelling for the transaction in the absence of such debt financing (namely, the transaction would be unlikely to generate the private equity sponsor's target internal rate of return), private equity sponsors are limited in the size of the investments they are permitted to make pursuant to their partnership agreements and therefore may not be able to purchase the entire business with an all-equity investment. As a result, private equity sponsors historically required a financing condition, and more recently, in lieu thereof, the ability to terminate the purchase agreement and pay a reverse termination fee to the target

company in the event that all of the conditions to the closing had been satisfied (or are capable of being satisfied on the applicable closing date) and the sponsor was unable to obtain the debt financing necessary to consummate the closing, as described in question 11.

In recent years, in addition to negotiating the right to terminate the purchase agreement and pay a reverse termination fee to the target company, some private equity sponsors have agreed to a limited specific performance remedy in which, solely under specified circumstances, target companies have the right to cause the shell acquisition vehicle to obtain the equity proceeds from the private equity fund and consummate the transaction. In the relatively few instances in which such a limited specific performance right has been agreed, such right will arise solely in circumstances where:

- the closing has not occurred by the time it is so required by the purchase agreement (which is typically upon the expiration of the marketing period for the buyer's third-party debt financing);
- all of the conditions to closing have been satisfied (or will be satisfied at the closing);
- the debt financing has been funded (or will be funded if the equity financing from the private equity sponsor will be funded); and
- in some cases the seller irrevocably confirms that, if specific performance is granted and the equity and debt financing is funded, then the closing will occur.

In addition, some private equity sponsors have agreed to give the seller the right to specifically enforce specified covenants in the purchase agreement against the private equity sponsor's shell acquisition vehicle (for example, using specified efforts to obtain the debt financing, complying with the confidentiality provisions, paying buyer expenses).



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