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Private Equity 2024

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Contributing Editor
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Freshfields Bruckhaus Deringer

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Global Practice Guides

Private Equity

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2024

Chambers Global Practice Guides

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INTRODUCTION

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Freshfields Bruckhaus Deringer has more than 270 years' experience globally and helps clients grow, strengthen and defend their businesses. Across the entire private capital spectrum, Freshfields Bruckhaus Deringer acts for financial investors including private equity, pension and sovereign wealth funds, infrastructure funds, alternative capital providers and real estate investors. Freshfields Bruckhaus Deringer covers deal structuring and execution, acquisition financing, fund structuring, tax, restructuring, competition and regulation, compliance and litigation, and delivers fully integrated advice to financial investors wherever in the world they invest.

Contributing Editor

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INTRODUCTION

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The 2024 Landscape for Private Equity Transactions

The 2024 M&A markets are recovering from a period of disruption. Disruption resulting from, among others, geopolitical events, rising interest rates, inflation, an energy crisis in Europe, and volatility in capital and financial markets. There is currently a gap between seller price expectations, on the one hand, and buyers' views on valuations and financing costs, on the other. The resulting slowdown in deal-flow is impacting both the exits of financial investors from portfolio businesses, and their ability to put to work the funds that their investors have committed.

The Outlook

The outlook for private equity nevertheless remains very positive. Global mega-trends will drive attractive investment opportunities; these include digitalisation, decoupling, population growth and ageing societies in some mature markets (leading to, for example, increasing demands on healthcare), decarbonisation and energy transition, and efforts to address infrastructure spending deficits.

Globally, the amount of capital available for private equity and other private capital investments has over the last years risen to unprecedented levels. A further increase can be expected.

Additionally, an increasing number of private equity investors are branching out and expanding the types of asset classes and transactions they target. Whether it is infrastructure, debt, venture capital, growth, or minority investments – "private equity" is becoming "private capital" and expanding its reach accordingly.

Private Equity in an Increasingly Regulated World

The continuous evolution of regulation is a key legal trend impacting private equity transactions across jurisdictions. There are rising scrutiny and enforcement levels, whether in antitrust or foreign investment regulation. Several private equity transactions have now successfully cleared the EU foreign subsidies regime, with more filings anticipated going forward. And, in times of geopolitical volatility, the ever changing sanctions regimes impact investments.

Private Equity Transactions by Negotiated Agreement

Most private equity transactions are concluded by negotiated sale and purchase agreement. Private equity investors may take the role of buyer or seller (upon exit) – or, in a secondary buyout, both.

M&A market terms tend to vary from one jurisdiction to another. There are markets that typically are more seller friendly (most European jurisdictions, with the UK known to be particularly seller friendly). Other markets are more buyer friendly (with the USA as a good example). Sometimes, market terms are also a function of market maturity; eg, less developed markets tend to have greater variability in terms.

Notwithstanding different M&A market terms around the world, private equity investors typically take very similar positions in negotiated transactions, regardless of jurisdiction and market practice. It is useful to look at these typical private equity positions both from a buy-side and a sell-side perspective.

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Private Equity Buyers

Consideration mechanism

Private equity buyers are usually comfortable with either a locked-box or a completion accounts consideration mechanism.

In a locked-box sale and purchase agreement, the purchase price is determined based on a historic balance sheet of the target business. The purchase price is then fixed in the sale and purchase agreement (sometimes subject to interest or a per diem amount). The buyer is protected by ordinary course and no leakage provisions (ie, the locked-box). For a private equity buyer, this has the advantage of high certainty at signing regarding the amount of the purchase price that will become due at completion. There is little risk of unexpected over- or underfunding. Market practice in European jurisdictions, such as France, Germany, the UK, Austria, Switzerland, Sweden and Spain, favours locked-box consideration mechanisms.

By contrast, in a completion accounts mechanism, the purchase price is not calculated and trued up until after completion. The purchase price is based on a completion date balance sheet of the target business and calculation rules set out in the sale and purchase agreement. This gives the buyer the comfort that the purchase price is determined concurrently with the buyer taking control of the target, with no interim (locked-box) period. There are situations where completion accounts are the only appropriate approach, such as in complex carve-outs or other circumstances where there are no historic accounts for the target business that a locked-box could be based on. Also, longer regulatory clearance periods may lead to completion accounts becoming more popular with buyers to reduce the risk of changes in the target business during the pre-closing period of the transaction. Completion accounts mechanisms are common in the USA, China, Canada, Japan, Brazil and Singapore.

Conditionality

Like any other buyer, a private equity investor will aim to use conditionality as a risk mitigant if possible and where advisable. However, market practice and the level of competition in the specific deal environment generally dictate which conditions are acceptable to sellers.

In all jurisdictions, market practice allows regulatory conditions, particularly in respect of suspensory antitrust, foreign investment and foreign subsidies regimes.

However, financing conditions are uncommon in most jurisdictions, where instead sellers typically expect buyers to provide proof of “certain funds” at signing – regarding both equity and debt financing. Financing conditions are seen in the US market and are not wholly unusual in China.

US M&A transactions will often include the repetition of representations and warranties and the absence of litigation as conditions. Third-party consents and “no material adverse effect/change” (MAE or MAC) conditions are often included in US deals as well. MAE or MAC conditions have been uncommon in Europe in the last decade.

In the USA, a buyer is often required to pay a reverse break fee if it exercises a termination right, particularly if a debt financing condition was included and not satisfied. In Europe, however, (reverse) break fees are not a common feature, even where transactions face material concerns that conditions may not be satisfied by the agreed longstop dates.

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Warranties and indemnities

Notwithstanding the thorough due diligence that they typically conduct, private equity buyers usually seek contractual protection against identified risk items. This often includes pre-closing tax and other risks that buyers are aware of at signing and that can be covered by indemnities (rather than price reductions, which tend to be seen unfavourably in competitive situations).

In all markets, private equity buyers try to ensure robust warranty protection in respect of fundamental risks, such as ensuring title to shares. In more seller-friendly markets, such as in Europe, warranties covering business risks are sometimes not offered by sellers or are made subject to extensive limitations. In these situations, private equity buyers, in addition to relying on their due diligence, often consider bridging the gap between the seller's and their respective positions by taking out warranty and indemnity (W&I) insurance. In many places this can be done for a modest additional cost. W&I insurance is, however, still unusual in some markets, such as China, Japan, the Philippines, and Brazil.

Private Equity Sellers

Exit certainty and control

Firstly, an important prerequisite for selling, and a common feature in all private equity deals, is that the private equity investor seeks to retain full flexibility and freedom to trigger and successfully drive an exit on its own terms, without restrictions from, for example, management shareholders or co-investors. Corresponding rights of the private equity investor are typically included in the shareholders' agreement.

It is also important to a private equity seller to be able to deliver the entire target business to the chosen buyer. This is often achieved by structuring an exit so that it takes place at a level of the investment structure where the investor has sole control over the sold entity. If that is not possible, the investor will want to rely on drag-along rights – whereby it can force minority shareholders to sell at the same terms. Drag-along rights are common in private equity transactions globally. Sometimes, these are subject to economic protection for the minority shareholders, such as in the form of minimum price or return thresholds.

In some jurisdictions, there are specific conditions that must be satisfied for a drag to be enforceable. It is common in many markets for co-shareholders that are subject to a drag to also have a tag-along right under certain circumstances.

Terms of sale

In most cases, a private equity seller will prefer a locked-box consideration mechanism in the sale and purchase agreement, as this entails far-reaching protection on price.

In addition to price protection, and subject to what market practice (and buyers) allow, private equity sellers usually seek to limit the conditionality of transactions so that they enjoy completion certainty. In all markets, the exceptions are conditions in respect of suspensory antitrust, foreign investment, foreign subsidies and any other regulatory clearance requirements.

Private equity sellers are very focused on minimising post-closing liability to maximise flexibility of a swift repatriation of proceeds to fund investors. Typically, therefore, they aim not to provide business warranties or indemnities, and try not to have to hold back proceeds in escrow or similar mechanisms. In all markets, remaining warranty protection is subject to limitations, such as caps, thresholds and de minimis provisions. If indemnities cannot be avoided, they

tend to be narrowly tailored and have bespoke limitations. One of the reasons why W&I insurance has risen to previously unknown levels of popularity in many jurisdictions is that it is an effective bridge-building tool, allowing private equity sellers a clean exit while at the same time providing buyers with substance-backed W&I protection.

In some jurisdictions, such as the UK, it is not unusual for members of management to provide warranties, particularly if they are themselves shareholders. Sometimes, management warranties are used in combination with W&I insurance to cover the substantive risk.

Public Deals and IPOs

Public-to-private transactions represent a small portion of all private equity transactions. They are commonly seen for example in the USA, Germany and the UK. Public deals are often voluminous and yield an attractive differential between the public and private market valuations of the target business. However, in many markets, the likelihood of the successful execution of public deals tends to be lower than that of private deals, and there is less reliance on customary or "market standard" terms. Also, there are legal barriers to public-to-private transactions in some jurisdictions, such as in China. Most public takeover regimes have mandatory offer thresholds, pricing rules and a disclosure regime for significant shareholdings (and, in some jurisdictions, there are broad concepts of attribution of target shareholdings between funds and investment/portfolio companies).

The popularity and frequency of private equity exits by IPO varies as a function of the volatility of capital markets more generally. In Europe in particular, dual-track exits (ie, where a sale and an IPO are pursued in parallel) are common for larger portfolio businesses, in times where the capital markets are receptive.

Management Equity and Other Incentives

The alignment of interests between the private equity investor and the portfolio company management is a key feature of private equity transactions globally. The approach to management incentivisation in detail varies from jurisdiction to jurisdiction, as do the preferred or typical structures. The structuring of management incentives is often tax-led. In many jurisdictions, equity investments by management are frequent and the easiest way of ensuring "skin in the game". Sometimes, management equity is combined with a management co-investment, which further increases alignment. Alternative approaches such as options, participation in investor proceeds, virtual share programmes and exit bonus arrangements are also common in some jurisdictions.

Management incentive schemes typically include mechanisms that allow the investor to call or forfeit the incentives of a leaver, with the economic consequences varying according to the nature of the circumstances of the departure (ie, whether the situation concerns a "good leaver" or a "bad leaver"). Many schemes include vesting features that allow managers to secure their position in the scheme over time.

In almost all markets, managers are subject to restrictive covenants, such as non-compete and non-solicitation. These can be part of the equity arrangements or set out separately in employment agreements.

AUSTRALIA

Law and Practice

Contributed by:
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Gilbert + Tobin is one of Australia's leading advisers to private equity funds and other financial buyers and fund managers. Its Band 1 team has been involved in many of the market-shaping private equity transactions in Australia in the last ten years, and it has extensive experience in dealing with the key issues that drive financial sponsors' businesses. Its team works with regulated M&A experts to help solve complex public-to-private transactions, as well as its banking and infrastructure experts, who look at the strategic and financial needs of its clients. Its lawyers across Sydney, Melbourne and Perth bring disciplined, effective and experienced management to large structured deals, leveraging cutting-edge technology and remaining flexible and open to novel opportunities.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

2024 has been another active year for private equity. As is to be expected, private equity funds have remained intrepid in the face of dynamic and challenging macro-economic conditions (discussed further in **1.2 Market Activity and Impact of Macro-Economic Factors**).

Private equity has been active in public markets, with the announcement of a number of high-profile take-private transactions (eg, KKR's AUD2.175 billion acquisition of Perpetual's corporate trust and wealth management businesses). Competition among private equity firms has increased as well, as funds look to deploy their dry powder, with certain assets attracting attention from multiple private equity suitors (eg, AirTrunk). Pre-bid stakes continue to feature in a number of deals, as private equity bidders seek to cement any first mover advantage.

General partners are also employing innovative deal structures and strategies to maximise flexibility and transaction certainty where the bid-ask spread is too wide or the deal is otherwise proving too hard to close. We have seen an uptick in private equity funds pursuing corporate carve-outs, minority-stake acquisitions and sales to continuation funds to secure value-creating transactions. As the cash rate starts to slowly normalise in Australia, there is a resurgence of corporates evaluating their core businesses, highest-value assets and overall strategic direction. We expect this to drive an increase in demerger and corporate carve-out transactions, as corporates divest non-core assets and streamline their businesses. Private equity funds looking for buy-side opportunities are likely to become increasingly involved in these transactions (eg, Perpetual's sale of its corporate trust and wealth management business units to KKR).

In relation to exits, the first half of 2024 has shown there may be early signs that the IPO window is opening. The offer of Guzman y Gomez shares raised AUD335 million and realised a market capitalisation of approximately AUD2.23 billion. Generally, however, the first half of 2024 continued to be slow for IPOs. From the frothy highs of 2021 (where IPOs raised AUD12 billion), approximately AUD600 million was raised from only seven IPOs in the first half of 2024. This has meant IPOs are still not considered to be a reliable exit strategy, leading some general partners to look at alternative liquidity solutions.

1.2 Market Activity and Impact of Macro-Economic Factors

Macro-economic factors have had a significant impact on M&A activity in 2024. The year has, similar to 2023, been characterised by high interest rates and therefore more expensive debt. Continuing geopolitical tensions such as the ongoing Russia-Ukraine and Israel-Palestine conflicts have challenged supply chains and markets for certain important inputs such as wheat and oil, contributing to inflation and amplifying the impact higher rates have had on the economy and broader consumer confidence.

On the deal-making front, the proliferation of AI and software has continued to garner the attention of private equity funds. In 2024, private equity has been particularly focused on the professional services and financial sectors, with notable activity in the IT and software sectors. Similarly, Australia's ageing population is greatly increasing the demand for healthcare services, and the country's abundant natural resources present opportunities to capitalise on the global decarbonisation trend.

On the financing side, given the higher cost of debt financing, general partners have turned towards alternative providers of credit in search of greater flexibility and more competitive terms (aligning with a global surge in the private credit market). Australian superannuation funds are also stepping in to assist, as well as the credit arms of global private equity firms (eg, KKR and Bain). This coincides with two of Australia's largest superannuation funds, AustralianSuper and Rest, planning to increase their allocations in private equity to 5% (from 3%) and 9% (from 5%) respectively within the next few years.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

For private equity funds and their portfolio companies, the most significant recent legal developments have been in relation to:

- the Australian Competition and Consumer Commission's (ACCC) proposed merger reform;
- certain aspects of the Foreign Investment Review Board's (FIRB) approach to evaluating approvals; and
- increased FIRB application fees.

ACCC Proposed Merger Reform

Traditionally, Australia has had a voluntary notification system for merger clearance in relation to M&A transactions. In April 2024, the Federal Government announced substantial changes to the merger control regime following the ACCC's year-long lobbying for reform. The reforms convert Australia's merger process from a voluntary regime to a mandatory regime for certain transactions. This means merger parties will be prevented from completing a transaction that exceeds certain thresholds unless they have notified the ACCC and the deal has been cleared.

The merger notification thresholds are still being developed but will involve both monetary values (eg, revenue and turnover) as well as market share measures. The thresholds will be set so that the ACCC will continue to be notified of and assess approximately 300 mergers each year.

One factor affecting whether a transaction is notifiable is if it is part of a series of roll-up acquisitions, whereby a series of (potentially small) acquisitions over a period of time aggregate to have a substantial impact on competition in a given market. Specifically, all mergers within the previous three years by the acquirer or the target will be aggregated for the purpose of assessing whether the proposed transaction meets the notification thresholds. There has been recent enforcement action from the ACCC in respect of roll-up acquisitions, such as in Woolworths' acquisition of PETstock and Viva Energy's acquisition of OTR Group. In the Woolworths/PETstock acquisition, the ACCC's approval was conditional on PETstock agreeing to divest 41 retail stores, 25 co-located veterinary hospitals, four brands and two online retail stores.

The proposed merger reform is currently undergoing consultation. It is expected to come into effect on 1 January 2026.

Updates to the FIRB Regime

New method of evaluation

FIRB announced on 1 May 2024 that it will now progress low-risk applications more quickly by concentrating its resources and attention on applications that are deemed higher risk. Applications may be considered to be high risk due to the nature of the acquirer (first-time investors and foreign government investors are likely to

attract higher scrutiny) or the nature of the asset being acquired (investments in assets such as critical infrastructure, critical minerals and critical tech are more likely to be considered high risk).

Additional approval conditions

There have been discernible trends in FIRB's approach to approval conditions in recent years. Among other things, FIRB has heightened its focus on tax evasion risks – as part of this, private equity applicants must accept 'standard tax conditions' (which are generally non-negotiable other than in exceptional circumstances). FIRB has also been observed to impose additional requirements on private equity applicants more frequently, including notification requirements (eg, regarding disposals above a certain threshold, often 10%, in the relevant asset or company). Additionally, for private equity funds, we have seen an increase in interest from FIRB around structuring – this is particularly the case where bidders, upstream special purpose vehicles or funds are domiciled across one or more low- or no-tax jurisdictions. FIRB and its consultation partners (including the Australian Taxation Office) expect these structures to be explained, and additional conditions to notify FIRB of disposals of assets ahead of time may be imposed.

Increased foreign investment fees

In July 2022, FIRB application fees doubled. The fees are also indexed annually. From 1 July 2024, the maximum cap on FIRB's fees is AUD1,171,600. The significance of these fees (and the fact they are generally non-refundable) is impacting the deal strategy for some private equity buyers. For example, in competitive sale processes, private equity buyers have historically considered applying for FIRB approval early in the process so that their offer was, ideally, less conditional at the time it was made – this is no longer as prevalent, with a number of private equity buyers only applying to FIRB when they have a signed sale agreement (or have at least been granted exclusivity).

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

In the private M&A context, parties generally enjoy considerable freedom to negotiate and agree the sale terms and the method by which the transaction is implemented. That said, in certain circumstances, engagement with regulators may be required (as discussed below).

In the public M&A context, private equity buyers and sellers are subject to the rules and requirements of the Australian corporate legislation – the main obligations being those set out in the Corporations Act 2001 (Cth) ("Corporations Act"), and most particularly in Chapter 6. The Corporations Act regulates the ways in which interests in listed Australian companies and unlisted Australian companies with more than 50 shareholders can be acquired, as well as the circumstances in which a person must disclose their acquisition or disposal of an interest in a listed Australian company. To the extent that the company is listed on the Australian Securities Exchange (ASX) (whether or not it is an Australian company), the company must also comply with the ASX Listing Rules.

ASIC

The Australian Securities and Investments Commission (ASIC) is Australia's corporate regulator. It has primary responsibility for matters relating to financial services, markets and consumer credit matters, and oversees enforcement of the Corporations Act.

All Australian companies (including those owned by private equity funds) must notify ASIC of changes to their capital structure, officeholders and the passing of certain resolutions (among other things). However, ASIC does not ordinarily become involved in private M&A in Australia.

ASIC does have a broader role to play in relation to public M&A in Australia. For schemes of arrangement, ASIC is directly and actively involved, and it reviews (and in most cases comments on) the disclosure document that is provided to target shareholders in relation to the scheme. ASIC is not directly involved in takeover offers in Australia. However, by virtue of its role overseeing compliance with the Corporations Act (including Chapter 6), ASIC often becomes involved in relation to potential breaches of the relevant provisions that arise in the course of the takeover. ASIC's involvement in public M&A transactions is particularly relevant to private equity buyers given their regular involvement in such transactions.

ASIC has had a particular focus on 'greenwashing' in recent years. In 2024, ASIC has shown a willingness to take action where it considers this has occurred. For example, in June, ASIC lodged civil penalty proceedings in the Federal Court against LGSS Pty Ltd as trustee of the superannuation fund Active Super, alleging misleading conduct in relation to superannuation products and claims that it would not invest in companies that derive any revenue from, among other things, gambling, tobacco and oil tar sands. Following from the Vanguard case in 2023, this again demonstrates active enforcement by ASIC in relation to greenwashing.

FIRB

As discussed above, foreign persons and investors controlled by foreign persons may need FIRB's approval to acquire an Australian company. The approval comes in the form of a 'notice of no objection' from the Australian Treasurer, which sets out certain conditions that the applicant (ie, the foreign person, such as the private equity fund) must comply with in connection with the proposed acquisition (plus certain ongoing reporting and other obligations following completion of the acquisition).

It is possible to apply for an exemption certificate in respect of, among other things, proposed acquisitions of Australian companies. If an exemption certificate is granted, the buyer can acquire the relevant companies (FIRB often requires the companies, or at least the category and type of company, to be specified) without needing approval in respect of each acquisition. These can be valuable to portfolio companies seeking to undertake a number of acquisitions.

Due to the breadth of what constitutes a foreign person under the relevant legislation, almost all foreign and most medium-to-large Australian private equity funds are characterised as 'foreign' and therefore need FIRB approval to acquire Australian companies.

ACCC

As discussed in section **2.1 Impact of Legal Developments on Funds and Transactions**, the ACCC regulates competition matters in Australia. The proposed merger reforms, when passed into law, are expected to come into effect from 1 January 2026 and substantially alter the way merger activity is monitored and notified in Australia.

Australian Takeovers Panel

Unless the transaction is proceeding by way of scheme of arrangement, the Takeovers Panel is the principal forum for resolving takeover dis-

putes in Australia. The only exceptions to this are criminal prosecutions and certain other proceedings commenced by ASIC or referred to ASIC by the Takeovers Panel itself or by other public authorities.

The Takeover Panel's primary responsibility is to determine whether the circumstances in respect of a takeover are 'unacceptable'. The Takeovers Panel makes this assessment not only by considering the black letter law of Chapter 6 of the Corporations Act, but by applying a pragmatic and commercial lens to the relevant circumstances. The Takeovers Panel has the ability to make broad orders if it considers that unacceptable circumstances have arisen.

4. Due Diligence

4.1 General Information

Private equity buyers, along with their advisers, usually undertake extensive due diligence investigations before irrevocably committing to acquire a target. This due diligence often covers commercial, financial, accounting, legal and tax matters (and in some cases technical matters). The focus areas generally reflect the buyer's existing knowledge of the business and broader sector, the risk profile of the company/sector, any specific requirements from debt and/or equity providers, and the time available (which can be driven by whether it is a bilateral or competitive sale process).

From a legal perspective, due diligence generally covers the following:

- corporate – capital structure, constituent documents, shareholders' agreement (or similar), incentive arrangements, and board papers and minutes (usually from the last three years);
- material contracts – key customer/supplier contracts and joint venture arrangements;
- real property – freehold and leasehold interests;
- related party arrangements – material arrangements with shareholders and/or directors;
- banking and finance – existing debt facilities and financing and security arrangements and any other arrangements necessary to understand the target's debt position, obligations to financiers, historical compliance with debt covenants, and any guarantees or similar security provided by or on behalf of the target;
- employment – key employment agreements, template employee and contractor agreements, and material policies;
- IP – material intellectual property owned or used;
- IT, privacy and data protection – material IT agreements and policies relating to privacy and data protection;
- litigation, disputes and investigations – litigation searches, and review of any threatened, anticipated, pending or current litigation and investigations into the target;
- regulatory and compliance – any applicable regulatory frameworks that apply to the business, and material licences and authorisations required to operate it; and
- anti-bribery and corruption – systems and policies related to applicable laws combating bribery and corruption, money laundering, terrorist financing, economic sanctions and fraud.

4.2 Vendor Due Diligence

When a private equity seller runs a competitive sale (or auction) process, it is customary

for potential bidders to be provided with certain vendor due diligence reports. In most cases, these reports cover accounting and legal issues, and in some cases tax issues. The reports are initially provided to potential bidders on a non-reliance basis, with the successful bidder being given reliance.

From a legal perspective, the legal vendor due diligence report generally looks relatively similar to a buy-side due diligence report. Just like a buy-side report, it generally covers the usual areas for legal diligence (see **4.1 General Information**). A key difference is how the information is presented – in a buy-side report it is usual to make recommendations as to how to deal with any issues that are identified (eg, completion should be conditional on any material third-party consents that are required), whilst in a vendor report that information is more usually objectively presented, with the potential bidders then left to form a view as to how they wish to deal with the relevant issues.

The benefits of undertaking legal vendor due diligence is that the private equity seller can:

- identify and address potential issues that may impact the proposed transaction or reduce the purchase price before the bidders discover them;
- have greater control of the narrative in relation to any likely issues;
- help drive the optimal legal and tax structure for the sale;
- more easily answer a bidder's questions regarding the business; and
- make the sale process more efficient.

5. Structure of Transactions

5.1 Structure of the Acquisition

The majority (at least by number) of acquisitions by private equity buyers are undertaken by way of private treaty acquisition. However, the acquisition of Australian companies with more than 50 shareholders must, for the most part, be undertaken by way of takeover bid or scheme of arrangement.

Companies With Fewer Than 50 Shareholders – Private M&A

In most cases, private M&A is undertaken by way of a negotiated share sale agreement (ie, a private treaty transaction). Private equity buyers ordinarily acquire a 100% interest, or otherwise a controlling interest, in the relevant company by acquiring the relevant shares. Control of the company or its business can also be obtained by the private equity entity subscribing for shares in the company (by way of a subscription agreement) or acquiring the business from the company (by way of a business sale agreement). The advantage of acquiring the business is that, unless otherwise specifically agreed, the buyer does not acquire the company's residual liabilities (eg, under material contracts with third parties) and can cherry-pick the assets that it wants. However, this can result in additional complexity and, largely for this reason, share acquisitions are more common.

In theory, the acquisition terms should be materially the same regardless of whether the buyer(s) and seller(s) are negotiating on a bilateral basis or the sale is part of a competitive process. However, in practice, the buyer may need to accept less favourable terms if there is competition for the asset.

Companies With More Than 50 Shareholders – Public M&A

In most cases, public M&A is undertaken by way of takeover (off-market or on-market) or scheme of arrangement. Schemes are more common than takeovers (with off-market takeovers the far more common of the two takeover structures), especially in the case of transactions above AUD1 billion (at least 80% of such transactions per year were undertaken by scheme since 2018). Private equity buyers, often driven by a desire to obtain 100% of the target (with schemes having a 75% threshold for this versus 90% under a takeover) and a need to do due diligence (customarily to facilitate debt funding and/or equity co-investment), have an even stronger bias towards schemes.

Pure auction processes are not really a feature of public M&A. However, it is not uncommon for a rival bidder to emerge, which does create a competitive process. Where there is a rival bidder, the original bidder often has to improve its terms (eg, by increasing the purchase price or waiving conditions) to secure the asset.

5.2 Structure of the Buyer

Private equity buyers customarily incorporate an Australian special purpose vehicle to acquire the target company. This ‘BidCo’ is typically a wholly-owned subsidiary of an Australian incorporated holding company (ie, a HoldCo). It is not unusual for a number of other Australian companies to also be incorporated as part of the group – this often includes a MidCo or a MezzCo. The companies do not have any trading history, assets (other than shares in the other entities) or liabilities (other than under the transaction agreements in relation to the acquisition).

Private equity buyers rarely agree to, and strongly resist, the fund itself entering into the sale agreement. Sellers can sometimes request this (among other things, to guarantee the BidCo’s obligations under the sale agreement); however, they can often be satisfied with the provision of equity and debt commitment letters to demonstrate the BidCo’s ability to fund the acquisition.

5.3 Funding Structure of Private Equity Transactions

Private equity deals are normally financed with a combination of equity and debt. It is customary for sellers to be given copies of equity commitment letters to provide the certainty of the equity funding. Certainty also needs to be provided regarding the debt funding – in most cases, this is done with a debt commitment letter that attaches the associated term sheet (with the key commercial terms, other than the aggregate amount of debt to be provided, redacted). Sale agreements customarily impose restrictions on what can be done in relation to the commitment letters (eg, the buyer cannot reduce the amount of equity covered by the equity commitment letter), and the buyer provides certain representations and warranties regarding the commitments – a material breach of these can entitle the sellers to terminate the sale agreement.

In the context of public M&A, the Australian takeover rules require bidders to have a reasonable expectation of funding before a bid is announced.

5.4 Multiple Investors

True consortium arrangements between private equity funds are rare in Australian private treaty transactions. A key factor in this is the relatively limited pool of appropriate targets and the number of private equity funds looking to deploy capital. Consortium arrangements are slightly more common in large public M&A – for example, the Brookfield-led consortium involving Morrison &

Co (among others) that acquired Uniti Group for AUD3.4 billion in 2022 – due to the amount of capital required to complete mega-deals.

In the context of private treaty transactions, what is more common is for there to be passive investment alongside the primary private equity buyer. Offshore institutional investors and superannuation trustees (including those attracted by competitive performance and favourable fee arrangements) sometimes invest alongside the general partner of the main fund in a specific portfolio company. In most cases, this is done through a separately structured co-investment vehicle governed by a standalone set of agreements.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Private equity buyers tend to determine the most appropriate consideration mechanism for acquisitions on a case-by-case basis. Some businesses (and indeed some entire sectors) lend themselves to a 'locked box' (no adjustment to the agreed purchase price absent unauthorised leakage by the seller), whilst others are better suited to completion accounts (purchase price is adjusted, in favour of either the buyer or the seller, following completion if the agreed metrics (eg, working capital or net debt) are not at the levels agreed). Earn-outs and deferred consideration structures (eg, holding a part of the purchase price in an escrow account for a period of time) are also relatively common, in particular where there is some uncertainty about the future performance of the business or an actual or perceived risk to it (eg, a potential third-party claim). When the seller is also a private equity fund, there is generally a reluctance for the consideration to be deferred in this way.

It is common for private equity buyers to incorporate a special purpose vehicle as the BidCo (see **5.2 Structure of the Buyer**). Assuming that is the case, it is customary for the sellers (in particular, sophisticated corporates or private equity funds) to insist on the buyer providing equity and debt commitment letters to demonstrate its ability to fund the acquisition. It is usual for the buyer to give the sellers representations and warranties in relation to these arrangements (see **5.3 Funding Structure of Private Equity Transactions**).

6.2 Locked-Box Consideration Structures

Given the recent rise in interest rates, some sellers are seeking to be paid interest on the purchase price between the locked-box date and completion. The rationale is that, as the deal was priced at a historic point in time, the seller should be treated as having sold at that point and should benefit from interest on the purchase price from then until completion (ie, when the money would actually be paid).

In the same way, some private equity buyers are seeking interest on any leakage that occurs during the locked-box period. The approach to interest is often reciprocal.

6.3 Dispute Resolution for Consideration Structures

Where the parties agree to use completion accounts, it is customary for a specific dispute resolution procedure to apply to the determination of any adjustments under the completion accounts regime. In most cases, one party will prepare the completion accounts and the other party will have the opportunity to challenge them to the extent it does not agree with them. If the

parties cannot agree the completion accounts within a specified time period, an independent expert (usually, an appropriately qualified accountant) is engaged to make a determination.

Where the parties agree to use a locked box, any disputes tend to be dealt with under the dispute resolution framework (eg, arbitration, court proceedings, etc) that applies to the sale agreement more generally.

6.4 Conditionality in Acquisition Documentation

Private equity buyers tend to insist on, and in most cases get, a relatively high level of conditionality in private treaty acquisitions. In addition to conditions regarding any necessary approvals from regulators (eg, FIRB, ACCC and the Australian Prudential Regulatory Authority, etc), it is common to have conditions regarding third-party consents (although the list of required consents is almost always heavily negotiated), key executives entering into new employment contracts and the satisfactory resolution of any business specific issues (eg, any proposed pre-completion restructure). Material adverse change provisions are also becoming more common, although these are generally resisted by sellers and heavily negotiated (in particular, the relevant triggers and exceptions). It is less common to have finance or shareholder approval conditions in private treaty transactions.

6.5 "Hell or High Water" Undertakings

In Australia, it is very rare for private equity buyers to agree to "hell or high water" undertakings. Sellers do, on occasion, ask for them where they consider there to be a real prospect of the ACCC (or an equivalent foreign regulator) taking a particular interest in the transaction. Even where a seller does ask for such an undertaking, and the private equity buyer is prepared to make some concessions, the negotiated outcome usually falls well short of "hell or high water".

6.6 Break Fees

Break fees are rare in the context of private treaty acquisitions in Australia. Reverse break fees are even rarer still.

However, break fees are effectively standard in recommended public M&A transactions in Australia. Typically, a break fee is an agreed amount that becomes payable if certain specified events occur that prevent the takeover or scheme of arrangement from proceeding (such as a change of recommendation by one or more of the target directors or a rival bid emerging). Generally, a break fee not exceeding 1% of the target's equity value is considered acceptable by the Takeovers Panel.

Reverse break fees are also becoming increasingly common in recommended public M&A transactions. This year, consistent with the last few, approximately 50% of bidders agreed to pay a reverse break fee to the target in certain circumstances. This is usually agreed in exchange for the target agreeing not to sue the bidder for damages under the implementation agreement. This is usually advantageous to the target as it may find it difficult to quantify its loss. However, it can also be detrimental because the reverse break fee usually acts as a cap on the bidder's liability, potentially limiting the target's recoverable loss to less than its actual loss.

The cap on break fees of 1% of the target's equity value does not apply to reverse break fees (although the prohibition on penalties under Australian law still applies). However, it is usually the case that the break fee and reverse break fee are the same amount.

6.7 Termination Rights in Acquisition Documentation

Private equity buyers usually require a right to terminate private treaty sale agreements if one of the following occurs:

- a condition precedent for their benefit is not satisfied or waived (if applicable) by the agreed date;
- a material breach of a seller representation or warranty;
- a material breach of the sale agreement (eg, of the conduct of business restrictions); or
- an insolvency event in relation to a seller or a member of the target group.

A seller can usually terminate sale agreements in similar circumstances. However, in practice sellers' termination rights are narrower – this is because it is customary for fewer of the conditions precedent to be for the benefit of a seller, the scope of the buyer's representations and warranties are narrower and the buyer has fewer obligations under the agreement to breach.

A long stop date of six months from the sale agreement is typical.

6.8 Allocation of Risk

Historically, private equity buyers and sellers have adopted different starting positions to risk allocation from corporates. This could be seen most acutely in the context of post-completion claims in respect of breaches of representations and warranties and under indemnities – private equity generally sought such protections as the buyer, but heavily resisted such exposure as the seller (which led to interesting negotiations when private equity was on both sides of the transaction). For the most part, corporates' position was more variable.

Private equity sellers' reluctance to have any post-completion exposure has, in part, contributed to the increase in usage of warranty and indemnity insurance in Australian private treaty transactions (it can also be used in public M&A; however, this is much less common). Warranty and indemnity insurance protects either a seller (in the case of a sell-side policy) or a buyer (in the case of a buy-side policy) from financial loss that may arise in the event that there is a breach of warranties and/or indemnities given by the seller in the sale agreement.

Private equity funds (whether on the buy side or the sell side) tend to insist on warranty and indemnity insurance being used in private treaty transactions. As such, whilst risk allocation still remains a function of the specific circumstances of the transaction (eg, the parties' relative bargaining power (including whether the acquisition is part of a competitive sale process), the parties' comfort with the headline purchase price and consideration structure, the identified and inherent risks that apply to the business, etc), warranty and indemnity insurance has in effect narrowed the gap between what private equity and corporates are willing to accept.

6.9 Warranty and Indemnity Protection

As set out in **6.8 Allocation of Risk**, private equity funds (whether on the buy side or the sell side) tend to insist on warranty and indemnity insurance being used in Australian private treaty transactions. On the basis that the majority of the warranties and indemnities are covered by the insurance policy (see below for some of the customary exclusions and limitations), it is customary for a seller to provide standard representations and warranties covering:

- its title to the sale shares;

- its authority and capacity to enter into the sale agreement and perform its obligations under it;
- certain aspects of the business (eg, accounts, assets, material contracts, compliance with laws, employees, intellectual property, information technology, property and tax, etc); and
- the sufficiency and accuracy of the information provided to the buyer during due diligence.

The warranties are supported by an indemnity in favour of the buyer. It is also customary for the buyer to be given an indemnity for any tax issues the target has. Additional indemnities for known or likely issues are negotiated on a case-by-case basis.

In most cases, the buyer will have two to three years from completion to bring a claim for breach of a representation or warranty (except regarding tax), and seven years for breaches of the tax warranties or under the tax indemnity. Assuming there is warranty and indemnity insurance in place, the seller will generally not have any personal liability for breach of warranties or under the tax indemnity (except for in the case of fraud). If there is no insurance in place, the seller's liability will be capped at the purchase price.

De minimis thresholds also apply. That is, the buyer cannot bring a claim (either against the insurer, if there is insurance, or against a seller, if there is no insurance) unless the amount recoverable meets a specified threshold. Generally, each individual claim must exceed 0.1% of the purchase price and the aggregate amount recoverable must exceed 1% of the purchase price.

Even if there is insurance in place, the buyer will generally not be able to recover under the policy for losses that arise from:

- known or disclosed risks, including matters that are the subject of a specific indemnity in the sale agreement;
- forward-looking warranties;
- warranties in areas where the insurer considers that there has been insufficient due diligence;
- certain environmental or contamination issues;
- bribery and corruption;
- fines and penalties not insurable under law;
- underfunding of pension plans;
- misclassification of employees/independent contractors; or
- transfer pricing, post-completion tax or stamp duty liabilities.

Where the parties do not put warranty and indemnity insurance in place, there will nonetheless be limits on the buyer's ability to claim from the seller for breach of warranty or under the indemnities. In most cases, the warranties and indemnities are qualified by (and the buyer cannot claim in relation to):

- materials uploaded to the data room, including any Q&A;
- information accessible on an agreed list of public registers (eg, such as company and land registries); and
- information contained in a disclosure letter, which contains specific disclosures against the warranties in the sale agreement.

Members of the management team will not usually provide warranties in their personal capacity (as distinct from the warranties they may provide in their capacity as shareholders in the target).

On that basis, this regime only applies to management in their capacity as shareholders.

6.10 Other Protections in Acquisition Documentation

As outlined in **6.8 Allocation of Risk**, private equity funds (whether on the buy side or the sell side) tend to insist on warranty and indemnity insurance being used in private treaty transactions. Subject to the limitations set out in **6.9 Warranty and Indemnity Protection**, the policy ordinarily covers the fundamental warranties, business warranties and most tax matters.

The use of warranty and indemnity insurance means it is not necessary for a private equity seller's obligations to be backed by escrow or retention arrangements.

6.11 Commonly Litigated Provisions

It is not uncommon to have disputes in relation to private treaty sale agreements in Australia. In most cases, these relate to purchase price adjustments (whether in connection with completion accounts or alleged leakage in the context of a locked box), earn-outs and non-competes. However, in most cases the parties resolve the relevant dispute commercially before formal litigation commences.

7. Takeovers

7.1 Public-to-Private

Private equity-backed bidders are common in Australian public-to-private transactions. There has been notable public M&A activity in the first six months of 2024 (more than AUD16 billion of deals announced). About 48% of the 2024 activity was private equity driven.

Bidders can acquire control of publicly held companies in Australia in various ways. The most common ways are by takeover bid or scheme of arrangement. In general terms, a takeover bid involves an acquisition undertaken by making offers to the shareholders of the target company. Once sufficient shares have been acquired (normally above 50%), control of the target will pass to the bidder, which will then be able to appoint new directors and control the company's operations. A takeover can be done on-market or off-market (the latter is more common). It is possible to have a friendly (recommended by the target board) or hostile (not recommended by the target board) takeover. On the other hand, a scheme of arrangement becomes binding on all shareholders once it is approved by a majority of shareholders (including 75% of votes cast) and also by the court. Schemes are driven by the target and so, unlike a takeover, can only be done on a friendly basis.

The bidder and target enter into an implementation agreement (which sets out things such as the offer price, conditions, steps the parties must undertake to effect the transactions, and break fees and deal protection mechanics) in respect of a friendly takeover and a scheme of arrangement. The target board plays a significant role in public-to-privates – including recommending that shareholders accept the offer or support the transaction (in accordance with the terms of the implementation agreement) in the context of a friendly takeover or scheme (as applicable), and recommending that shareholders not accept the offer in respect of a hostile takeover.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Under Australian law, a person that has, either alone or together with their associates, control over 5% or more of voting shares in an ASX-

listed company has a "substantial holding" in that company and must fulfil certain notification requirements. A person must, within two business days, give a notice that sets out certain details of their holding (including their name, their address and the basis on which they have the interest in the shares) to the company and to ASX once they:

- begin to have, or cease to have, a substantial holding; or
- increase or decrease a substantial holding by 1% or more.

A person making a takeover bid for a listed company is also deemed to have a substantial holding in the target during the takeover period. Therefore, whenever there is a movement of at least 1% in the bidder's holding, the bidder must notify the company and ASX by 9.30am on the next trading day.

7.3 Mandatory Offer Thresholds

The Australian takeover rules are underpinned by a number of prohibitions. The key prohibition applies where:

- there is an acquisition of control over issued voting shares in an ASX-listed company, or in an unlisted company that has more than 50 shareholders; and
- that acquisition results in the number of shares controlled by one person or their associates (being entities in the same corporate group, entities with which the bidder has entered into an agreement for the purpose of controlling or influencing the composition of the board of the target company or the conduct of its affairs, or entities with which the bidder is proposing to act in concert in relation to the target company's affairs) increasing:
  - (a) from 20% or less, to more than 20%; or
  - (b) from a starting point that is above 20% and below 90%,

unless an exception applies. The main exceptions allow acquisitions under a formal takeover bid or under a formal scheme of arrangement, acquisitions approved by target shareholders, or creeping acquisitions of no more than 3% in a six-month period.

This means a private equity bidder (or indeed any other person) cannot purchase a stake greater than 20%, unless it does so under an exception (such as under a formal takeover bid or scheme of arrangement). In other words, unlike in the UK, there is no 'mandatory offer threshold' that permits a bidder to buy a stake over 20% (for example) provided it then makes a bid to other shareholders.

7.4 Consideration

The nature of consideration that a bidder is allowed to offer under a takeover differs depending on whether it is an off-market or on-market bid. Only cash may be offered for an on-market bid, whereas cash, scrip, or a combination of cash and scrip may be offered for an off-market takeover. The most common form of consideration offered by bidders is straight cash, with approximately 70% of bidders in takeover transactions that were announced and became unconditional in the first half of 2023 (up to 31 July 2023) offering cash only.

In the context of a takeover, the consideration offered for target shares must equal or exceed the maximum consideration that the bidder or an associate provided, or agreed to provide, for a target share during the four months before the bid. There are particular rules for determining the value of pre-bid non-cash consideration, and for

applying this rule where the consideration under the bid is or includes scrip.

7.5 Conditions in Takeovers

On-market takeover bids must be unconditional. This is one of the primary reasons that they are relatively uncommon (compared to off-market takeover bids).

Off-market takeover bids may be subject to conditions, and common conditions include:

- minimum acceptance conditions (50% or 90%);
- conditions relating to material adverse changes in the financial or trading position or condition of the target;
- conditions requiring government approvals (such as FIRB approval or ACCC clearance); and
- conditions relating to adverse movements in market indices or in key commodity prices.

The bid can be subject to finance (provided it is framed in a way that means its satisfaction does not turn on the bidder's opinion or events within the bidder's control – see below). In practice, few takeovers contain such a condition due to the uncertainty it provides.

Certain conditions are also prohibited. These include:

- maximum acceptance conditions;
- conditions allowing the bidder to acquire securities from some but not all of the accepting shareholders;
- conditions requiring approval of payments to officers of the target ceasing to hold office; and
- conditions that turn on the bidder's opinion or events within the bidder's control.

The position is largely similar for a scheme of arrangement, except that minimum acceptance conditions are not applicable in the context of schemes (which are all-or-nothing transactions).

In the case of a friendly off-market takeover bid or a scheme of arrangement, it is customary for the parties to agree exclusivity arrangements in the implementation agreements. These generally include:

- 'no shop' or 'no talk' agreements, under which the target agrees not to solicit rival proposals from third parties and, subject to a fiduciary exception, not to negotiate with potential rival bidders; and
- notification and matching rights, under which the target agrees to notify the bidder if it receives an unsolicited proposal from a rival bidder, and not to recommend that proposal unless and until it has given the initial bidder a short period (usually three business days) to match or better that proposal.

7.6 Acquiring Less Than 100%

A scheme of arrangement is an 'all-or-nothing transaction'. If the requisite conditions (including target shareholder approval) are satisfied or waived (to the extent that they are capable of waiver), the bidder will acquire all of the shares of the target that it does not already hold. If the conditions are not satisfied or waived, the bidder will not acquire any shares.

Under a takeover, a bidder is able to compulsorily acquire all of the shares it does not hold if it holds at least 90% of the shares in the relevant class and acquired at least 75% of the shares that it offered to acquire under the bid. If the bidder ends up with more than 50% but less than 100% of the shares in the target, a private equity buyer will be entitled to reconsti-

tute the board and will be largely able to control the strategic direction of the company (eg, M&A, dividend policy, etc). Bidders must set out their intentions regarding the target if their shareholding ends up at this level in the disclosure document in relation to the takeover bid, and ASIC will require the bidder to act in accordance with its disclosed intentions. Further, whilst the target remains listed on ASX, it will remain subject to the ASX Listing Rules as well as the Corporations Act even if it ceases to be listed, which will, among other things, require the bidder to obtain shareholder approval for certain transactions (including related party transactions).

7.7 Irrevocable Commitments

In Australian public M&A transactions, it is not uncommon for private equity bidders to secure pre-bid commitments from existing shareholders to increase the likelihood of them obtaining control over the target (including by acting as a disincentive to any potential rival bidders).

These commitments can take the form of, among other things, call options (under which the bidder can acquire the relevant shares in certain circumstances), pre-bid acceptance agreements (under which a shareholder agrees to accept the takeover offer) or voting agreements (under which a shareholder agrees to vote in favour of the scheme of arrangement). Such arrangements are generally entered into prior to the initial approach to the target and are subject to certain conditions (eg, no superior proposal emerging for the target).

8. Management Incentives

8.1 Equity Incentivisation and Ownership

It is customary for private equity buyers to seek to align management's interests with theirs by putting in place a management equity plan (in some cases, to sit alongside a cash incentive plan) following their investment in, or acquisition of, the company. Management's equity participation will generally be limited to 5%–10%.

8.2 Management Participation

Management participation can be structured as either sweet equity or an institutional strip. Where employees roll their existing securities (whether they vested as a result of the private equity shareholders' acquisition of, or investment in, the company or otherwise), they generally participate in the institutional strip. In respect of a management equity plan, or the rolling of unvested incentives, employees generally receive sweet equity.

In most cases, this takes the form of options or loan-funded shares issued in accordance with the terms of the management equity plan. Management is not usually issued preferred securities. The preferred treatment given to these types of securities (eg, redeemable preference shares) is usually reserved for the private equity shareholder.

8.3 Vesting/Leaver Provisions

As set out in **8.2 Management Participation**, management equity plans generally contain time-based and/or performance-based vesting conditions. For the time-based conditions, these are often linked to the private equity shareholder's proposed timeline to exit its investment in the company (eg, three to five years). For the performance-based conditions, these are often linked to the financial of the company or the relevant business divisions (ie, those in which the employee is involved).

The leaver provisions are often among the most heavily negotiated aspects of management equi-

ty plans (given employees will likely lose some or all of their benefits if they are a bad leaver). A relatively customary construct is for someone to be a bad leaver if their employment is terminated for cause or they resign, and for them to be a good leaver if their employment ceases for any other reason.

8.4 Restrictions on Manager Shareholders

It is customary for manager shareholders' employment contracts, as well as often the management equity plan for the company, to include provisions preventing management shareholders from competing (including by way of solicitation) with or disparaging the company. The private equity shareholder and the company are also often given rights under the shareholders' agreement in respect of breaches.

Such provisions – in particular, non-competes – must operate in a certain way to be enforceable under Australian law. Although the exact requirements vary depending on the relevant Australian State or Territory, throughout Australia only reasonable non-compete clauses are legally enforceable. That is, they should be no more restrictive than is necessary to protect the employer's legitimate business. The provisions must be carefully drafted to ensure that they are enforceable.

8.5 Minority Protection for Manager Shareholders

Manager shareholders' minority protections depend on the nature (ie, the class of securities that they hold) and size of their shareholding. It is not unusual for manager shareholders to have veto rights over a limited a set of actions (eg, amendments to the company's constitution or shareholders' agreement), where that action would prejudice them in a manner that is materially and adversely disproportionate as compared to the rest of the company's shareholders. Manager shareholders will also have the benefit of certain Corporations Act protections (eg, in relation to directors' duties and oppression against minority shareholders) and common law protections. Where manager shareholders have a larger holding in the target – whether because they rolled as part of the acquisition of the company or as a result of the company's incentive plan – they may have broader protections, although seldom do managers have any specific anti-dilution protection or the ability to control or influence the private equity shareholder's exit from the company.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

It is typical for private equity shareholders to have very high degrees of control over their portfolio companies.

Where there is a material minority shareholder in the portfolio company, that minority shareholder will usually have the benefit of certain limited minority protections. These protections will be set out in the shareholders' agreement, and require the minority shareholder's consent to be obtained for actions such as material acquisitions or disposals, related party transactions, departures from the agreed dividend policy and payment of directors' fees (with the list to be negotiated at the time the shareholders' agreement is entered into).

Where the portfolio company is wholly owned (including where members of management hold securities pursuant to an incentive plan), the private equity shareholder's control will be subject

only to the company's constituent documents and general Australian law (eg, as set out in **8.5 Minority Protection for Manager Shareholders**, the shareholder oppression provisions).

9.2 Shareholder Liability

In Australia, shareholders are generally not liable for the actions of the company in which they own shares. Their liability is limited to the capital they have contributed to the company – for example, a private equity firm cannot be liable for the actions of its portfolio company. This is referred to as the 'corporate veil'.

There are, however, circumstances in which the corporate veil can be pierced and a shareholder may be liable for more than its contributed capital. These include where a shareholder uses the company to commit fraud or its nominee is deemed to be a shadow director and therefore subject to directors' duties.

10. Exits

10.1 Types of Exit

In addition to trade sales (to other private equity investors or corporates) and IPOs, there has been an increase in the use of continuation funds (being vehicles established by the sponsor to acquire an asset from an existing vehicle operated by the same sponsor, effectively a general-partner-led secondary) in the last 12–24 months.

Trade sales remain the most common private equity exit route. The use of 'dual track' processes (ie, the concurrent pursuit of a trade sale and IPO) is still rare, largely as a result of the challenges in relation to public markets exits (see **1.1 Private Equity Transactions and M&A Deals in General**).

It is not common for private equity sellers to reinvest upon exit.

10.2 Drag and Tag Rights

In Australia, drag rights and tag rights are, effectively, standard in shareholders' agreements for companies with private equity shareholders. However, in practice, these provisions are used relatively rarely.

Drag Rights

These provisions allow majority shareholders, when they are selling at least the agreed percentage of their shares in the company, to force the minority shareholders to also sell their shares (usually on materially the same terms). The drag threshold is generally somewhere between 60% and 80% of all shares on issue. However, whilst management shareholders will almost always have to sell their shares if the drag rights are validly effected, it is not uncommon for the consent of institutional co-investors to have to be obtained before they can be dragged.

Tag Rights

These provisions allow minority shareholders, when the majority shareholders are selling at least the agreed percentage of their shares in the company, to force the majority shareholders to also procure the sale of their shares (usually on materially the same terms). The tag threshold is generally somewhere between 10% and 20% of all shares on issue.

10.3 IPO

As set out in **1.1 Private Equity Transactions and M&A Deals in General**, IPO activity in the first half of 2024 broadly mirrors that in 2023 but there are signs that the IPO window might be opening again following the listing of Guzman y Gomez, and subsequently with Bain Capital indicating that it is looking to refresh its plans

to relist Virgin Australia on ASX after taking it private in 2020.

The approach to lock-up (or escrow) arrangements has, however, remained unaffected. These arrangements comprise either mandatory (ie, ASX-imposed lockup) or voluntary (ie, determined by the issuer, usually in conjunction with the lead manager(s) of the IPO) escrow arrangements that, in most cases, run for a period of 12–24 months from the IPO. In some cases, certain shares may be released from escrow once the issuer's financial results are announced to ASX.

It is common practice for private equity sellers to enter into relationship agreements with issuers to govern their ongoing relationship following the IPO. These agreements generally deal with the private equity seller's rights to appoint a nominee to the board and its information rights, and can also sometimes set out the basis on which the issuer will assist with a sell-down of the seller's shareholding.

Trends and Developments

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Gilbert + Tobin is one of Australia's leading advisers to private equity funds and other financial buyers and fund managers. Its Band 1 team has been involved in many of the market-shaping private equity transactions in Australia in the last ten years, and it has extensive experience in dealing with the key issues that drive financial sponsors' businesses. Its team works with regulated M&A experts to help solve complex public-to-private transactions, as well as its banking and infrastructure experts, who look at the strategic and financial needs of its clients. Its lawyers across Sydney, Melbourne and Perth bring disciplined, effective and experienced management to large structured deals, leveraging cutting-edge technology and remaining flexible and open to novel opportunities.

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Market Overview

The first six months of 2024 have been dynamic for the Australian private equity sector. Due to the various challenges the global economy has experienced, private equity funds have had to recalibrate, using innovative and novel approaches to sustain their deal-making.

A key challenge has been dealing with 'sticky' inflation, which although easing, has done so more slowly than expected. This has brought the era of cheap capital to an end, with global central banks holding interest rates at higher levels than in recent history. Beginning on 4 May 2022, the Reserve Bank of Australia (RBA) raised rates for 11 consecutive months, taking the cash rate from 0.10% to 3.60% by March 2023. By the end of 2023, three additional hikes saw the cash rate reach 4.35% – the highest level since December 2011.

The RBA has held the cash rate steady at 4.35% since November 2023. The RBA and the broader market previously predicted interest rate cuts to occur in 2024; however, persistent core inflation has all but ruled out that possibility. Headline inflation in Australia has remained one of the highest among major advanced economies due to a tight labour market, higher energy prices, sustained migration and cost-of-living price increases (among other factors). Markets are now expecting the first rate cut to occur in 2025, which is a contrast to certain other advanced economies (such as Singapore and the UK) that have already initiated rate cuts. As a result, the cost of debt in Australia has remained elevated in 2024, presenting a challenge for private equity buyers.

Geopolitical factors have also caused challenges. The continuing Russia-Ukraine conflict has inflated certain input costs, with companies forced to modify their supply chains to avoid disruption and to ensure stability (often at a higher price). In a similar vein, the Israeli-Palestinian conflict has created uncertainty and further complicated operating conditions for select private equity investments. Compounding this, consumers in various jurisdictions are spending less across the board, reducing many companies' revenues. For example, private equity groups General Atlantic and CVC Capital Partners have paused sale processes for multimillion-dollar stakes in companies that operate US fast food brands such as Starbucks, KFC and Pizza Hut in Indonesia and Malaysia as a result of protests and boycott campaigns disrupting those businesses and their valuations.

These concerns are one of the forces driving the 'deglobalisation' trend, with countries seeking to gain independence in relation to critical goods and services. For example, the US Government has provided Samsung a USD6.4 billion subsidy to build silicon chip factories in Texas in an effort to bring advanced and critical computer chip-making back to the United States. Donald Trump has vowed to impose a blanket 10% tariff on all imports and a 60% tariff on goods imported from China if he is elected President later this year. Similarly, the Australian Government has committed AUD22.7 billion as part of its 'Future made in Australia' policy announced in the 2024-2025 budget. At its core, the Federal Government is seeking to protect Australia's long-term national interest by investing in its domestic capability in order to provide economic resilience, security and independence.

The rising geopolitical tensions have also contributed to greater scrutiny of foreign investment into Australia. The Foreign Investment Review Board announced on 1 May 2024 that it will assess applications using a revised risk-based

approach to ensure resources are devoted to the highest-risk applications. The government will apply special scrutiny to investments in critical infrastructure, critical minerals, critical technology, investments in proximity to sensitive government facilities and investments that involve holding or accessing sensitive data sets. The geopolitical conflicts have acutely highlighted how inextricably linked critical infrastructure and national security are, and the Australian Government is taking steps to enhance and protect Australia's long-term national interests in these areas.

Private equity hotspots

Despite these challenges, private equity funds have been active deal-makers in 2024 as the new investing environment becomes better understood. While in 2023 deals were very much buyer-driven, the increased pressure to return capital to investors and a shrinking bid-ask spread look set to enliven sellers and bolster mergers and acquisitions activity for the rest of 2024.

Notably, private equity sponsors are still armed with plenty of dry powder accumulated over the past five years that needs to be deployed. We are increasingly seeing this capital being deployed in non-control transactions (that is, where the sponsor takes a less than controlling share of the company) where targets have growth potential. These strategies have been proving value-accretive and often involve founders/management that are committed to longer-term growth remaining in the business.

Overall, there are positive signs that activity will continue to increase in the second half of 2024, particularly in certain key sectors.

Two particular hotspots are worth mentioning. The first is the renewables, energy and critical minerals space. From 2017 to 2024, 62% of the aggregate capital raised by Australia-focused infrastructure funds was for energy funds, up from 39% for infrastructure funds closed between 2010 and 2016. The Australian Government has also been driving capital to develop clean energy. For instance, Clean Energy Finance Corporation, an Australian Government-owned green bank, invested alongside private market investors in two of the largest infrastructure funds closed in the past five years: the AUD3.4 billion QIC Global Infrastructure Fund and the AUD1.4 billion Pacific Equity Partners Secure Assets II Fund. This demonstrates the Government's continued commitment to the energy transition and highlights the importance of infrastructure-related deals more broadly.

Australia is poised to monetise its raft of renewable resources, including solar, hydro, wind and its valuable deposits of minerals such as lithium and copper. A case in point is the AUD26.2 billion merger of Newcrest and Newmont, which created one of the world's largest gold and copper businesses. Private equity funds are following these developments and are looking to capitalise on similar opportunities. While Brookfield was unsuccessful in its AUD20 billion proposed acquisition of Origin, we expect private equity funds will continue to look for opportunities to privatise and invest in the renewables space.

The second hotspot has been the interest in artificial intelligence (AI) and tech-adjacent businesses. After the incredible rally by Nvidia, which surged past Apple and Microsoft to temporarily become the most valuable company in the world, private equity is looking closely at AI and its potential (much of which is still untapped). Nvidia's stratospheric rise reflects the eye-

watering sums being ploughed into AI. According to Goldman Sachs, USD400 billion will be invested globally next year, with private equity funds being one of the leaders in this space.

Increasingly, private equity funds are looking to invest in companies where AI can be deployed to significantly enhance operational efficiency and streamline workforces. For example, financial and professional service businesses have seen an uptick in private equity interest as GPs seek to leverage the power of AI to improve efficiencies and ultimately valuations in anticipation of a future exit. We expect this to continue.

Overall, while 2023 was characterised by widening bid-ask spreads and valuation gaps that made agreeing terms difficult at times, this trend is slowly reversing in 2024. Although the persistence of inflation and fiscal tightening by the RBA (and central banks around the world) created significant headwinds for the Australian private equity industry over 2023, the new year appears to have ushered in a new sense of optimism (perhaps even urgency) for PE dealmakers.

We have observed three key trends emerging in the Australian private equity ecosystem:

- valuation reconciliation between buyers and sellers;
- increasing use of single/multi-asset continuation funds to provide liquidity to investors; and
- developments in public markets deal-making (eg, IPOs and backdoor listings).

These trends are discussed in further detail below.

Valuation Reconciliation Between Buyers and Sellers

We are seeing the deal flow of private equity funds beginning to increase and expect this will eventually reach a tipping point, progressing from a desire to transact to a need to transact. Fundamentally, private equity funds do not store capital, they recycle it, and must regularly return capital to investors. After all, investor returns are the ultimate scorecard. While transactions involving continuation funds and similar innovative structures can relieve the pressure for distributions and liquidity in certain cases, private equity funds are re-evaluating their assets and taking a pragmatic view of value. Put simply, the bid-ask spread is shrinking. There is particular pressure on private equity funds that held assets acquired during 2018 and 2019, before the onset of the COVID pandemic, to return capital to their investors.

Many observers have noted that 2024 marks the beginning of a ‘valuation reconciliation’, which is spurring a steady return to normalised market conditions. In 2023, deal-making favoured the creative, with sponsors sustaining activity through public-to-privates, portfolio bolt-ons, minority transactions and continuation vehicles. In 2024, we expect this to continue, though we are seeing a return to more traditional majority buyout deal-making. While valuations have not shifted dramatically, the scales have started to shift in favour of buyers driven by some sellers’ need to transact and return capital.

Private equity funds are also sitting on record levels of dry powder. According to S&P Global, private equity dry powder reached an unprecedented USD2.59 trillion globally at the end of 2023. While the macroeconomic and geopolitical backdrop remains uncertain, the stabilisation of interest rates and the anticipation of gradual

rate cuts by the RBA appear to provide the right backdrop to unleash this capital.

Competing financing sources are also expected to bolster the buyout market as private equity funds look to both private credit and syndicated markets for the best financing terms for deals. The competition between the private credit market (with record amounts of capital) and the syndicated market (backed by banks with limited leveraged finance exposure) will strongly benefit private equity funds.

Continuation Funds and Novel Liquidity Solutions

Late 2023 was more subdued for fundraising given a number of strong raises in the previous 12 months and the dry powder judicious managers had held back. 2024 will pick up pace later in the year as deal deployment accelerates.

There has been considerable momentum towards the creation and use of various single/multi-asset continuation funds. We have seen a number of such funds close this year, with a number still in the pipeline.

This demonstrates the thematic shift of Australian private equity's expansion to longer investment horizons as private equity owners want to remain invested in high—quality cash-generating businesses. We expect this trend to continue to increase, especially as funds run up to end of fund-life and investors demand distributions and liquidity events.

These continuation funds are now also playing an important role in the democratisation of the private equity asset class as private equity firms design funds accessible to a greater number of high net worth individuals and family offices. There are numerous examples of large managers raising feeder funds from high net worth investors. There are also retail or semi-retail private equity products now listed on numerous investment platforms. These include Ellerston JAADE, Pacific Equity Partners' Gateway Fund and 5V's Horizon Fund.

Developments in Public Markets Deal-Making

Overall, more deals involving ASX-listed targets were announced in the first half of 2024 than in the first half of 2023. Private equity was involved in a number of them. While deal value is down compared with 2023, last year was skewed by several large bids, including Newmont's AUD24 billion bid for Newcrest and Brookfield's failed AUD20 billion bid for Origin.

Last year we observed that some private equity funds had broadened their approach to transaction structures and considered taking the bolder approach of proceeding with hostile takeover bids. This year, we are seeing a return to the status quo, with private equity funds preferring friendly transactions with due diligence access and a board recommendation to facilitate the debt financing normally required.

Against this backdrop, we have seen a number of interesting public markets transactions and themes emerge that we expect private equity funds will have regard to.

Buy-side themes: corporate carve-outs

The current macroeconomic landscape has also prompted a number of public companies to reassess their strategies and re-evaluate non-core or underperforming assets. Boards are obliged to consider all options to maximise value for shareholders, and demergers and carve-out transactions have proven to be an effective option, especially for mature businesses. Notable examples in recent history include Wool-

worths' demerger of Endeavour in 2021, which was closely followed by Tabcorp's demerger of The Lottery Corporation in 2022. More recently, New Zealand-based Fonterra announced in May 2024 that it was putting its Australian milk supply business up for sale, including a portfolio of household-name dairy brands. Treasury Wine Estates is similarly undertaking a strategic review and expects to demerge or sell its non-premium brands to concentrate on its premium wine business (including its renowned Penfolds label).

Acquirers in carve-out contexts have typically been other corporates with deep industry expertise. However, we have seen increased interest in them from private equity funds – we expect that to continue over the next 12 months, particularly as the Australian private equity market matures with the rise of a number of managers with niche strategies, which may be fund-wide or a focus; for example, Genesis Capital with its health sector focus, Roc Partners with their agricultural and food focus, and Advent Partners with their Software-as-a-Service focus (among certain other areas).

As the dynamics and consequences of demergers and carve-outs become better understood in the Australian market, it is not surprising to see private equity develop the sophistication to identify, participate in and drive these transactions. Private equity funds have been applying the magnifying glass to constituent business units, identifying carve-outs that present opportunities to drive growth and unlock greater value in these businesses. Perpetual demonstrates this trend. An approach by Soul Patts (formerly Washington H. Soul Pattinson) spurred a strategic review that led to an array of sponsors participating in the sale processes for its corporate trust and wealth management business units.

KKR, which has had a successful and lucrative track record of investing in Australian corporate carve-outs (eg, Arnott's and Colonial First State), recently entered into binding transaction documents to acquire Perpetual's wealth management and corporate trust businesses for AUD2.175 billion. We expect private equity funds to continue seeking out corporate carve-outs as they present opportunities to deploy dry powder on assets that historically may have been misvalued, lacked sufficient attention from management or were misaligned with other parts of the business. GPs focused on optimisation and equipped with financial resources can help turn these businesses around (as they have successfully done in the past) and convert them into profitable exits.

Sell-side themes

IPO market

In the first half of 2024, only AUD98 million was raised through IPOs – the second-lowest amount raised in the first half in over a decade. The IPO market has been grappling with economic headwinds in the last few years, particularly with the uncertainty around inflation and interest rates.

That said, there may be early signs that the IPO window is opening again following the successful listing of Guzman Y Gomez (GYG), and subsequently with Bain Capital indicating it is looking to refresh its plan to relist Virgin Australia on the ASX after taking it private in 2020.

The IPO of GYG was the first significant float in several years and one of the biggest Australian IPOs in the past decade. With capital markets quiet, many eyes were on this deal and on GYG's decision to opt for a public listing as opposed to a private sale. GYG listed on 20 June 2024 with an AUD2.2 billion market capitalisation after successfully raising AUD335 million. GYG's

share price closed 36% higher after its first day of trading, resulting in a market capitalisation of approximately AUD3 billion. GYG's performance exceeded expectations and may potentially reopen the window for the IPO market as a viable exit strategy for private equity funds. While there may not be a seismic shift in public markets activity any time soon, we expect private equity funds will certainly take notice of GYG's success and hope it foreshadows a revival of the coveted IPO exit strategy.

Backdoor listings

As direct IPOs have been hard to execute (as discussed above), private equity funds have been reminded that a backdoor listing is an alternative route to the public boards.

Chemist Warehouse is one of Australia's largest and best-known privately run businesses, and investment bankers have been exploring the idea of a public markets listing of the business since at least 2015. On 11 December 2023, Chemist Warehouse agreed to merge with Sigma by way of a scheme of arrangement that will see Chemist Warehouse join the ASX through a backdoor listing.

Backdoor listings are a unique alternative to IPOs where a listed company acquires an unlisted company and/or its assets, enabling the unlisted company to become publicly traded. This approach provides an alternative route to the ASX for private businesses, bypassing the traditional IPO process.

While we are seeing signs that the IPO window may be opening, we expect to see more instances of novel transaction-structuring if the IPO market continues to face difficulties. However, it is important to bear in mind that backdoor listings involve substantial complexity. For instance, although Chemist Warehouse is exempt from complying with ASX's admission requirements, Sigma must satisfy disclosure and legal obligations and submit a relisting prospectus for the merged entity. Additionally, Chemist Warehouse must, among other things, prepare and submit a scheme booklet and notice of meeting for its shareholders, and produce an Independent Expert's Report. That said, sophisticated private equity funds with experience completing complex transactions will be familiar with these documents, making backdoor listings a potentially attractive pathway in the right circumstances. Ultimately, we have no doubt this transaction has put front of mind another tool in the private equity toolkit to be used in the right circumstances.

BELGIUM

Law and Practice

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Van Olmen & Wynant is an independent law firm offering quality services in employment and corporate law and litigation, active since 1993. The firm has about 40 lawyers serving a wide range of business clients including growth companies, multinationals, public companies and government institutions. Van Olmen & Wynant has extensive experience advising both investment funds and managers in PE transactions, and has been the long-time advisor of prominent companies such as ING Private Equity and the (PE-backed) Dstny group. Based in Brussels, the firm enjoys outstanding international contacts with high-quality law firms across the globe.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

The mergers and acquisitions (M&A) and Private Equity (PE) markets have experienced fluctuations in deal activity since 2022. After two consecutive years of a shrinking volume of M&A transactions, which can, among other things, be ascribed to the pressure of escalating interest rates, combined with macroeconomic and geopolitical uncertainties, global deal volumes are beginning to stabilise. While the Belgian market initially proved more resilient, M&A experts point to a strongly declining trend in the country in 2023. The drop appears most pronounced for very large deals and private equity transactions.

The near future looks brighter, however. Despite ongoing geopolitical concerns, industry professionals do not expect the decreasing trend to continue in 2024. In fact, an upsurge in large transaction deal activity is anticipated. The expected rise is particularly significant for financial buyers, fuelled by an abundance of dry powder and anticipated cuts in interest rates.

1.2 Market Activity and Impact of Macro-Economic Factors

It is well established that small and medium-sized enterprises (SMEs) form the backbone of Belgium's economy, as they serve as the fundamental structures that sustain and drive its economic activity. Following increased activity within the SME sector in 2022, the Belgian M&A market has experienced a decrease in this deal segment during the past year, reflecting lower resilience to economic challenges.

However, given their importance in the local economy, SMEs remain appealing targets for acquisitions, particularly in the context of buy-and-build transactions. As the market is expected to stabilise, we can anticipate renewed interest and growth opportunities in this vital sector.

Impact of Interest Rates on PE Deals

One of the key features of the economic climate in 2023 is rising interest rates. These have a significant impact on PE deals, which often rely heavily on external debt financing. In 2023, the average NFD/EBITDA ratio has returned to its 2021 level, and remained relatively stable overall. The average ratio of net financial debt to EBITDA was equal to 3.2, which is consistent across various size segments. However, for the largest deals exceeding EUR100 million, this ratio averaged 4.0. The 2024 Belgian M&A Monitor, published by Vlerick Business School, provides an insight into the impact of rising interest rates following tighter monetary policy. According to the report, only 47% of industry professionals explicitly attribute the increased cost of debt financing to the decline in deal activity, and 59% noted a negative impact on valuation multiples. Moreover, they indicate a reduced recourse to debt in acquisition financing and an increased reliance on organic versus inorganic growth.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

The legal landscape in Belgium has witnessed significant developments in recent years, which are exerting a growing influence on M&A. Below is an overview of certain significant changes within the Belgian or European Union (EU) legal framework in recent years that have had an impact on the PE deal landscape.

Contract Law

As of 1 January 2023, Book 5 of the new Belgian Civil Code has become effective, primarily focusing on two main objectives: (i) codifying principles that are currently established through case law, and (ii) enhancing the autonomy of parties to independently address their concerns. The latter involves granting parties the authority to apply sanctions without seeking prior judicial intervention, thereby enabling unilateral actions such as price reductions or anticipatory terminations. It is important to acknowledge that several of these provisions function merely as supplementary laws, which can be made inapplicable upon mutual agreement by the parties.

Additionally, Book 6 of the new Belgian Civil Code on extra-contractual liability has been approved, and is expected to take effect at 1 January 2025. The new rules mark a significant shift from the traditional prohibition of combining contractual and extra-contractual liability, which could have a profound impact on M&A practices.

Sustainable Finance Disclosure Regulation (SFDR)

The EU has introduced the SFDR, which came into effect in two phases, partly on 10 March 2021, and partly on 1 January 2023. The SFDR outlines the requirements for financial market participants to disclose sustainability information, aiming to ensure that investors can make well-informed decisions. Moreover, the SFDR facilitates the assessment of sustainability risks in investment choices, empowering investors to evaluate them accurately.

For PE firms, adhering to SFDR is of utmost importance to safeguard their reputation and attract investors interested in sustainable products. Consequently, PE managers offering such products must implement effective environmental, social, and governance (ESG) strategies. This could include creating sustainable products, integrating sustainability principles into their company's structure, establishing streamlined reporting processes, and conducting thorough ESG due diligence.

Corporate Sustainability Reporting Directive (CSRD)

Effective from 5 January 2023, the CSRD has been enacted, replacing the EU's Non-financial Reporting Directive (NFRD). The primary objective of the CSRD is to enhance the legal framework surrounding mandatory ESG disclosures by large companies within the EU. To achieve this, the CSRD will be implemented gradually, with the first companies required to report in 2025 for activities carried out in 2024, and the last companies required to report in 2029 for activities carried out in 2028.

Large EU companies, who exceed certain thresholds set forth in the CSRD in terms of number of employees, turnover, and total assets, will fall under the purview of these regulations. Additionally, even non-EU companies generating more than EUR150 million in revenue within the EU or with an EU branch generating more than EUR40 million will also need to comply by 2029.

The CSRD will play a crucial role in providing access to comprehensive and standardised ESG information, allowing PE players to make better-informed investment decisions based on standardised and, in some cases, audited information.

Corporate Sustainability Due Diligence Directive (CSDDD)

The EU has enacted a second directive aimed at improving the ESG and corporate social responsibilities of companies active within the EU. The CSDDD was approved by the EU Parliament

on 24 April 2024 and by the EU Council on 24 May 2024. It will enter into force 20 days after its publication in the Official Journal, and member states will have two years from that date to transpose its provisions into national law.

The CSDDD imposes a duty on companies to identify and assess adverse impacts on human rights and the environment. This includes an obligation to map their operations, supply chains and business activities. If risks are identified, the companies will need to take action to prevent or mitigate these risks. This can be done, for example, by creating stringent policies or compliance procedures. The companies also need to be transparent about their due diligence efforts (the CSDDD mandates regular reporting and monitoring), and can be held accountable. Companies must also engage with relevant stakeholders and create an effective remediation procedure in the event that negative situations arise (eg, affected individuals or communities file grievances for solutions/remediation).

The CSDDD will impact private equity investment processes going forward, as investors will focus more on their targets' ESG compliance. Additionally, the CSDDD targets not only the company itself but also its entire supply chain, further complicating the due diligence process.

Foreign Direct Investments (FDI)

The Belgian legislature has implemented a new framework regarding the screening of foreign direct investments, which became effective on 1 July 2023.

This screening mechanism is designed to regulate foreign investments made by non-EU investors who intend to acquire, directly or indirectly, either 10% or 25% of the voting rights in Belgian entities or undertakings operating within specific strategic sectors. Transactions falling under the scope of the Belgian FDI regulation are required to undergo a mandatory filing process before the deal can be completed.

To oversee the Belgian FDI regulation, the Interfederal Screening Commission (ISC) has been established as the public supervisory authority.

The implementation of the Belgian FDI regulation will undoubtedly impact the process of (PE) deal-making in Belgium, affecting deal-certainty, the timing of transaction implementation and the provisions of the transaction documentation (such as an FDI clearance condition precedent).

Foreign Subsidies Regulation (FSR)

On 21 January 2023, the EU's FSR came into effect, introducing a set of regulations aimed at addressing market distortions arising from foreign subsidies in the EU. These rules are designed to maintain the EU's commitment to trade and investment openness while ensuring a fair and level playing field for all companies.

According to the SFR, the European Commission (EC) will be empowered to investigate financial contributions provided by non-EU governments to companies operating within the EU. If the EC determines that certain financial contributions create distortive subsidies, it will have the authority to impose measures aimed at rectifying the adverse effects caused by such distortions.

The FSR will introduce three key tools to address distortions caused by foreign subsidies:

- A notification-based tool for investigating concentrations – this tool applies when financial contributions granted by non-EU governments are involved in mergers, acquisitions, or joint ventures where at least one of

the parties involved generates a turnover of EUR500 million within the EU. The investigation is triggered if the transaction involves foreign financial contributions exceeding EUR50 million.

- A notification-based tool for investigating public procurement bids – this tool applies to public procurement procedures where financial contributions from non-EU governments are involved. The investigation is initiated if the estimated contract value is at least EUR250 million, and the bid includes a foreign financial contribution of at least EUR4 million per third country.
- A general tool for investigating other market situations – the EC has the authority to initiate investigations on its own accord in all other market scenarios not covered by the previous two tools. This enables the EC to proactively review and address potential distortions caused by foreign subsidies.

As with FDI, a deal falling within the scope of the FSR will be impacted in terms of deal-certainty, the timing of transaction implementation and the provisions in the transaction documentation.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

In Belgium, PE funds are subject to oversight from various regulatory bodies, particularly pertinent to private equity transactions. Some notable authorities involved in this supervision are outlined below.

Merger Control and Anti-competitive Behaviour – European Commission (EC)/ Belgian Competition Authority

The EC and the Belgian Competition Authority are both responsible for aspects of merger control regulations, depending on the size and region of (the entities involved in) the transaction.

Private equity-backed buyers engaging in M&A activities must assess whether the contemplated transaction meets the thresholds triggering mandatory notification to the EC, the Belgian Competition Authority or any other competition authority.

Aside from merger clearance, the EC and the Belgian Competition Authority also investigate anti-competitive behaviour of companies and state-aid matters.

Foreign Subsidies – European Commission (EC)

The EC is the supervisory authority charged with reviewing and investigating financial contributions provided by non-EU governments to companies operating within the EU under the Foreign Subsidies Regulation (FSR). As the regulation only entered into effect on 21 January 2023, parties should be aware that few precedents are available, for instance in terms of the timing of FSR clearance.

FDI Screening – Interfederal Screening Commission (ISC)

In Belgium, the Interfederal Screening Commission (ISC), established on 1 July 2023, is the public authority responsible for screening foreign direct investments.

Financial Services and Markets Authority (FSMA)

The FSMA is the Belgian regulatory authority responsible for supervising and regulating various financial and monetary activities, including those related to the formation of PE funds.

The FSMA plays a crucial role in ensuring compliance with financial regulations, investor protection, and market integrity. PE funds operating in Belgium must strictly adhere to the FSMA's guidelines and regulations, particularly in areas such as fund management, marketing, and disclosure obligations.

4. Due Diligence

4.1 General Information

Due diligence investigations are a critical component of M&A and PE transactions, including the performance of a comprehensive legal due diligence. Typically, a high-level, "red flag" due diligence is conducted to swiftly identify potential major issues and risks associated with the target. The scope of a legal due diligence conducted in Belgium is extensive and usually covers at least the following key areas (of course depending on the size, sector and other elements considered relevant by the buyer):

- Corporate – review of corporate documents, ownership structure, securities, governance, shareholders' agreements, and board minutes.
- Regulatory compliance – assessment of licences, permits, authorisations, and compliance with industry-specific regulations.
- Commercial contracts – examination of material customer and supplier agreements, distribution agreements, joint ventures, and intellectual property agreements.
- Employment – analysis of employment agreements, benefit plans, compliance with labour laws and employee relations.
- Intellectual property rights – verification of ownership, validity, and potential infringement risks related to trade marks, patents, copyrights, software, and trade secrets.
- Litigation and disputes – review of ongoing or potential legal disputes, regulatory investigations, and significant judgments or settlements.
- Real estate – assessment of property ownership, leases, permits, zoning compliance, and environmental liabilities related to the target's real estate assets.
- Financial matters – review of financial agreements such as credit agreements, guarantees, and security interests.
- ESG compliance – assessment of ESG policy (labour practices, diversity & inclusion, climate, etc).

It is common for a tax and financial due diligence to be conducted by specialised advisors, separately from the legal due diligence. Operational due diligence is carried out on a case-by-case basis.

4.2 Vendor Due Diligence

Vendor due diligence, whereby the seller of the target conducts a pre-sale due diligence investigation of the target, is becoming increasingly common in the sale of a PE-backed target as it facilitates a smoother transaction process and enables potential buyers to assess the target in a more efficient manner. In the context of a controlled auction sale – ie, the sale of a target whereby the bidding process is controlled and governed by the target itself – vendor due diligence reports (or similar reports) are typically provided to bidders after the acceptance of a non-binding offer submitted by a bidder.

The role of legal advisors in the preparation of the sale of a PE-backed target can consist of assistance with (i) the preparation and establishment of a virtual data room, (ii) conducting issue-oriented vendor due diligence or (iii) establishing a non-issued legal factbook (a descriptive report).

In controlled auction sales, bidders often rely on the vendor due diligence reports (or similar reports) provided by the sell-side advisers. In general, sell-side advisors in Belgium are willing to accept that the bidder may rely on its report, under standard conditions. Regardless of any reliance provided by sell-side advisors, depending on the specific circumstances of the transaction and the buyer's risk appetite, buyers will generally conduct their own additional (purchaser's) due diligence.

5. Structure of Transactions

5.1 Structure of the Acquisition

Private M&A Transactions

In Belgium, M&A transactions are commonly structured as share deals, the terms of which are set out in a sale and purchase agreement (SPA). Neither the execution of the SPA nor the transfer of the shares require the involvement of a notary. Mergers, where two or more legal entities become one legal entity, are relatively uncommon.

In a controlled auction sale, the sale process documentation (eg, the process letter) typically already sets out the deal-structure contemplated by the seller, which will usually be the private acquisition of the shares of the target by a buyer.

A common notion is that a controlled auction enables the sellers to negotiate or impose more favourable deal-terms than would be possible through a direct private negotiation between the parties.

Within the framework of such an auction, the sellers' advisors provide potential bidders with a process letter that outlines the procedure and instructions for potential bidders participating in the sale process. The process letter typically includes important information such as the envisaged timeline of the transaction, instructions for submitting bids, confidentiality requirements, details about the data room access, terms and conditions of the sale, and any specific requirements or qualifications that bidders must meet. It is important to note that a controlled auction can lead to better deal terms, especially in the event of multiple bidders; however, all transactions are tailor-made and the acquisition terms will depend on the specifics of the transaction and the bargaining power and position of the parties.

Public Takeovers

Publicly traded targets can be acquired by making a public offer to purchase the shares of the target directly from its shareholders (tender offers). While tender offers are not very common in Belgium, there have been some noteworthy instances of such offers in recent times. For example, the takeover bid for Telenet made by its majority shareholder Liberty Global, as well as the takeover bid for Exmar initiated by the Saverys family.

5.2 Structure of the Buyer

Acquisitions by PE funds, particularly in management buyouts (MBOs) or leveraged buyouts (LBOs), are commonly structured by the incorporation of an acquisition vehicle that, following the completion of the transaction, will serve as the new holding company for the target.

Such a special purpose vehicle is specifically incorporated for the purposes of (i) acquiring debt financing, (ii) acquiring the target and (iii) if applicable, the (re)investment of management in the special purpose vehicle. In this manner, the special purpose vehicle acquires the shares in the target directly and the PE fund owns all or a number of shares in the special purpose vehicle.

Irrespective of this "textbook" structure, it is worth noting that the actual structure can vary depending on the transaction and the preferences of the PE fund. Each deal is unique, and the structure will be tailored to meet the specific objectives and circumstances of the transaction.

5.3 Funding Structure of Private Equity Transactions

In Belgium, private acquisitions such as PE deals are typically financed through a combination of equity and debt. In general, the equity portion is provided by (i) the PE fund itself, and (ii) in certain scenarios, such as management buyouts, the seller(s) and/or managers (who will also acquire an equity stake). The debt portion is generally sourced from (i) third-party debt providers such as banks and (ii) seller(s) through a vendor and/or deferred payments. In this regard, we also noted that there was a notable increase in the proportion of M&A transactions involving vendor loans, especially for smaller and mid-sized deal segments. We also find that financial buyers tend to finance a slightly higher proportion of the deal price through debt compared to strategic buyers.

Vendor loans and deferred payments are typical financing components of a deal, whereby the seller provides a loan to the buyer in view of the partial financing of the acquisition.

Prior to the completion of a deal, the seller(s) or managers who are invited to (re)invest in the buyout holding may be requested to execute an equity commitment letter or wrapper agreement to this effect.

In some cases, the PE fund will give comfort in respect of the debt-funded portion of the purchase price by providing a (binding) term sheet signed by the third-party financing party(ies).

5.4 Multiple Investors

In the domain of private equity and venture capital, a consortium refers to an alliance comprising multiple investors or funds with a shared goal of pursuing a specific investment opportunity. Rather than an individual PE firm or investor operating independently, the consortium enables the pooling of resources, expertise, and capital from diverse parties.

Within Belgium's venture capital landscape, a substantial number of investments are effectively executed through consortia. In practical terms, a lead investor negotiates with the target company a term sheet outlining the critical transaction terms. Subsequently, the target company and the lead investor proactively seek out co-investors (ie, the consortium), collectively striving to achieve the desired investment amount.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

The purchase price is generally established either by (i) a closing accounts mechanism whereby the purchase price is calculated on the basis of the accounts of the target as per closing or (ii) by a locked-box mechanism, whereby the purchase price is calculated on the basis of the

accounts of the target on a date prior to closing (the locked-box date).

The fundamental distinction between these two mechanisms revolves around the point at which time the risk shifts from the seller to the buyer. With the completion accounts mechanism, this transfer takes place on the closing date, whereas with the locked-box mechanism, it occurs on the locked-box date.

The selected pricing mechanism determines the entire equity value of the target, which purchase price can be further subdivided in different components like the cash component, a vendor loan, a deferred payment, escrow amount, etc.

In the context of a closing account mechanism, the purchaser will usually pay an estimate of the purchase price at closing, which shall be finally determined post-closing.

PE deals generally include a locked-box price mechanism, as this mechanism does not necessitate post-closing adjustments (which can sometimes result in disputes). Consequently, it also provides certainty regarding the required (debt) funding needed to complete the transaction.

6.2 Locked-Box Consideration Structures

In Belgium, legally speaking – irrespective of the applied pricing mechanism (locked box or closing accounts) – the legal ownership of the target is transferred from the seller to the buyer at closing. From an economic point of view, however, when a locked-box pricing mechanism is employed, the target is transferred on the locked-box date (ie, a date prior to signing). The seller will continue to manage the activities of the target until closing, but the compensation for the seller will be calculated on the basis of the accounts on the locked-box date.

To mitigate the potential loss of equity value over the period between signing and closing, when parties adopt a locked-box price mechanism, parties may decide to apply interest charges ("equity ticker") or some other form of compensation for the period between the locked-box date and closing to the benefit of the seller(s).

As the name suggests, the target should – as of the locked-box date – remain "locked", meaning that the activities of the target should be carried out in the ordinary course of business and that the value of the "box" should be retained. The sale and purchase agreement will thus include a list of transactions between the sellers (or their affiliates) on the one hand, and the target on the other hand, which are not allowed in the period starting on the locked-box date and ending on the closing date (so called "leakage"). The occurrence of such leakage items will lead to a "euro-for-euro" reduction of the purchase price. Certain leakage transactions, typically referred to as "permitted leakage", will be allowed and will not impact the purchase price. These may include payments such as the sellers' management fees in alignment with past practices.

6.3 Dispute Resolution for Consideration Structures

The contractual documentation will often provide that disputes arising out of the application of purchase price or earn-out mechanisms shall be deferred to financial experts, such as registered auditors (bedrijfsrevisoren or réviseurs d'entreprise), who will be tasked with the final determination. Since the locked-box mechanism doesn't necessitate a post-closing price revision, there is typically less need to involve financial experts in such situations.

6.4 Conditionality in Acquisition Documentation

Depending on the specifics of a deal and the negotiating powers of the parties, the conditions to closing of the transaction can vary immensely between similar deals.

Deals are not often subject to third-party consent with the exception of merger clearance and FDI approval, which are fairly standard and uncontroversial.

If one of the target's material agreements contains a change of control clause, consent or waiver from the counterparty will typically be required by the purchaser.

Material adverse change clauses are relatively uncommon, given their far reaching potential consequences. The inclusion of material adverse clauses will inevitably lead to discussions regarding their definition.

6.5 "Hell or High Water" Undertakings

In its purest form, a "hell or high water" provision requires the buyer to take all necessary steps to satisfy measures proposed by regulatory authorities for the clearing of transaction.

These clauses impose an obligation for the buyer to accept any conditions (such as divestitures) imposed by regulatory authorities, even if those conditions could be materially detrimental to the target business. Given the inherent risks associated with such provisions, they are not customary and typically only accepted by buyers in highly competitive bid situations or when the buyer has a high level of confidence that the regulatory risks are manageable.

6.6 Break Fees

In Belgian private equity transactions, break fees, also known as termination fees, to the benefit of the seller are not commonly used. Similarly, break fees to the benefit of the buyer (also known as reverse break fees) are equally rare. As with most transaction terms, (reverse) break fees might be included depending on the negotiating leverage of each party and the deal specifics.

6.7 Termination Rights in Acquisition Documentation

In Belgium, the circumstances under which a PE seller or buyer can terminate the acquisition agreement largely depend on the terms specified within the agreement itself. Most sale and purchase agreements will contain a "no termination" clause whereby parties waive their rights to terminate or seek the annulment of the agreement, other than in certain specific circumstances listed in the agreement, such as:

- failure by a party to complete its closing obligations, which will typically allow the other party to choose between rescheduling the closing date or terminating the agreement; and
- failure to satisfy the conditions(s) precedent within the agreed timeframe (ie, by the longstop date), which will usually allow either party to terminate the agreement – the length of the longstop date in a transaction is contingent on the particularities of the deal (simple deals may have a relatively short long stop date (a few weeks), while agreements that require regulatory approvals or merger clearance may include a longer period, ranging from three to six months after the signing date).

6.8 Allocation of Risk

The performance of a due diligence investigation is an integral part of any PE transaction.

In Belgium, the allocation of risk between a buyer and a seller typically occurs through the granting of representations and warranties to the buyer. It is important to note that the contents of the data room will generally form an exception to the representations and warranties to the extent the information contained therein is "fairly disclosed".

Consequently, a purchaser who has identified a material risk during its due diligence may request that the representations and warranties be supplemented by (i) specific indemnities or (ii) conditions precedent (if the purchaser requires a certain measure to be taken before proceeding to closing).

In addition, the inclusion of a general tax indemnity has grown more common in PE-backed transactions over the last years, inspired by international practice.

The allocation of risk also often depends on the buyer's appetite. While some PE funds may possess a higher risk tolerance due to their sector experience, a PE fund with limited familiarity in the target's field might require extensive indemnities based on recommendations from its advisors. Experience also teaches that industrial buyers, who possess operational insight into the target's business and inherent risks, may be more willing to assume certain risks that are considered inherent to any entrepreneurial venture.

6.9 Warranty and Indemnity Protection

Private Equity-Backed Seller

A private equity-backed seller will usually give the same representations and warranties as the other sellers in the context of an M&A transaction, unless the shareholders' agreement entered into between the sellers (including the private equity-backed seller) would provide otherwise.

Representations and Warranties

In principle, a seller will always give representations and warranties to the buyer in an M&A transaction, relating to (i) the capacity of the seller and the unencumbered ownership of the shares (so called fundamental warranties) and (ii) the target's business (so called business warranties).

Standard fundamental warranties include:

- ownership of the shares or assets;
- absence of undisclosed liens, mortgages, pledges, security interests, or other encumbrances on the sold shares; and
- authority and power of the seller to enter into the transaction.

Standard business representations include:

- financial accounts;
- contracts and agreements;
- real estate;
- regulatory matters;
- intellectual property;
- employees;
- tax;
- insurance;
- environmental matters;
- information technology;
- data protection and personal data; and
- anti-bribery.

The above non-exhaustive list is merely an example, and the scope and extent of warranties should be tailored to the specifics of the transaction and the target's business and sector.

The seller's liability under the warranties is usually subject to data room disclosures, which is standard in the Belgian M&A market. This means that the seller will not be liable for a breach of warranties arising from matters that are "fairly disclosed" in the data room.

Specific Indemnities

Apart from warranties, purchasers frequently aim to incorporate specific indemnities to address particular risks identified during the due diligence process. For example, a pending litigation with an uncertain outcome could be covered by a specific indemnity provided to the buyer, thereby mitigating the risk associated with it.

Limitations

The indemnification obligation of the seller for breaches of warranties is typically subject to the following limitations:

- Time limitation – claims have to be notified by the buyer within a time period after closing. A longer time period, usually aligned with the applicable statute of limitations to be increased with a certain number of days, is typically provided for claims relating to tax and environmental matters.
- De minimis threshold – individual claims must exceed a minimum monetary amount in order to be taken into account for indemnification.
- Basket – the purchaser will only be indemnified if all claims taken together (following application of the de minimis threshold) exceed the basket threshold amount. Depending on the transaction, the basket may be "tipping" (ie, exceeding the basket amount means the purchaser shall be indemnified for the entire amount of the losses) or "non-tipping" (ie, the purchaser shall only be indemnified for losses exceeding the basket amount).
- Cap on liability – the seller's liability will be capped at a certain monetary amount, which could be between 10% and 30% of the purchase price, depending on the deal's size.

The above-mentioned limitations will usually not apply to specific indemnities, it being understood that the sale and purchase agreement will typically provide that the aggregate liability of the sellers under the agreement (including breaches of warranties or specific indemnities) can in no event exceed an amount equal to the purchase price.

6.10 Other Protections in Acquisition Documentation

Beyond the traditional warranties and indemnities, the acquisition documentation often incorporates several other forms of protection for both the buyer and the seller, such as non-compete and non-solicitation clauses, conditions precedent (such as regulatory approvals), and confidentiality agreements. In addition, the following other protections are sometimes included in M&A transactions:

- Warranty and indemnity insurance ("W&I insurance") – W&I insurance has gained traction in Belgian PE deals over the recent years, especially in the larger deals. W&I insurance is used comparatively more often in transactions where the seller is a PE firm. It is frequently used to cover breaches of representations and warranties as well as tax indemnities. It is, however, at least as of yet, not customary.
- Vendor loan – a vendor loan will often contain a provision stating that any outstanding amount of the vendor loan will be set of against any payment obligation of the seller under the transaction documents (ie, following a breach of warranties).

- Escrow account – part of the purchase price can be transferred to an escrow account which serves as a security in the case of a liability of the seller. This escrow account is usually held by a third-party escrow agent, typically a public notary, who acts as a neutral party and facilitates the transaction.

6.11 Commonly Litigated Provisions

In Belgium, litigation related to M&A transactions does not arise infrequently. Disputes often involve issues relating to representations, as well as warranties and liabilities. Matters considering consideration or earn-outs are typically deferred to third-party experts.

7. Takeovers

7.1 Public-to-Private

Public Takeover Bids and Private Equity

In Belgium, public-to-private transactions involving private equity-backed bidders occur rarely compared to some other jurisdictions, such as the United States. Such transactions are subject to specific regulations to ensure transparency and fair treatment of shareholders.

Target's Board Involvement in a Public Takeover Bid

Essentially, when initiating a public takeover bid, it is not mandatory to procure the approval of the target's board. Nevertheless, the board retains the prerogative to comment on the bid through two primary means: (i) it can provide commentary on the comprehensiveness and potential deceptiveness of the preliminary prospectus, and (ii) it can establish a response memorandum, within which dissenting views may be articulated. In practice, though, the response memorandum will usually align with the viewpoint of the controlling shareholders due to their representation within the board.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

A bidder intending to submit a public takeover bid is required to disclose this intention to the FSMA prior to initiating the bid. The FSMA then notifies the target entity, the general public, and the stock exchange.

Within this framework, the bidder formulates a prospectus that includes pertinent information about the bidder, its intentions, the target entity, the bid itself, and the financing structure for the bid. This prospectus is then published after receiving approval from the FSMA. Should the FSMA request additional information, the involved parties are obliged to provide all pertinent reasoning and explanations that could significantly influence the valuation of the bid.

7.3 Mandatory Offer Thresholds

In Belgium, a public takeover bid is legally required in the following situations:

- If an individual or group acquires over 30% of a company's outstanding voting securities, they must make an offer for all the remaining outstanding voting securities and securities that confer the right to acquire voting securities of the target company.
- Additionally, a mandatory takeover bid can be triggered if a person acquires a controlling stake in a holding company that owns more than 30% of the voting securities of the target company. This is applicable if the holding company's shareholding in the target company represents more than half of its net assets or average net results over the last three financial years, based on its last publicly filed unconsolidated financial statements.

It should be noted that the 30% threshold mentioned in the context of a mandatory takeover bid refers specifically to the number of securities with voting rights, and not the number of voting rights themselves. This means that the double voting right, which is allowed for Belgian listed companies, is not taken into account when determining the 30% ownership requirement.

7.4 Consideration

Voluntary Public Takeover Bid

In principle, in the context of a public takeover offer, a bidder has the freedom to determine the price and form of consideration offered to the target's shareholders, assuming they do not already possess a controlling interest in the target. The payment for the offered price can be made in cash, securities, or a combination of both. While there is no specific minimum price requirement for a voluntary takeover bid, the terms of the bid, including the price, should be reasonably expected to lead to a successful takeover.

In cases where there are different categories of securities in the target, different prices per category are only acceptable if they are based on the specific characteristics of each category. Additionally, if the bidder already holds control over the target, an independent expert will be tasked with drafting a valuation report for the target.

Mandatory Public Takeover Bid

In the scenario of a mandatory offer, there is a minimum price requirement which price must be equivalent to the greater of two factors: (i) the highest price paid by the bidder during the 12 months preceding the bid announcement, and (ii) the weighted average trading price over the 30 calendar days prior to the event that triggered the obligation to bid.

Moreover, a mandatory offer must be made in cash, or a cash alternative offered when other types of consideration (such as securities) are offered. This requirement ensures that shareholders have the option to exit their investment immediately, which may not be possible if the consideration is in the form of securities that may not be readily marketable.

7.5 Conditions in Takeovers

A voluntary offer may be subject to multiple conditions, subject to approval from the FSMA. These conditions can encompass various factors including acquiring approval from competition or other regulatory bodies, reaching a certain acceptance threshold, the non-occurrence of a significant adverse effect, the absence of dividends, no modifications to the target's articles of association, and so forth. It is essential that these conditions do not impede the potential success of the bid.

With regard to a mandatory offer, the main principle is that a mandatory offer must be unconditional. The bidder, having already obtained control of the target company, is not allowed to add conditions to the offer. This means that unlike in a voluntary offer, a bidder cannot condition a mandatory offer on factors such as the receipt of regulatory approvals or a minimum acceptance threshold.

7.6 Acquiring Less Than 100%

Governance

If a PE bidder does not seek or obtain 100% ownership of a target, it can still seek additional governance rights to influence the management and strategic direction of the target. These rights might include representation on the board of directors, veto rights over certain major decisions (such as mergers, acquisitions, or significant capital expenditures), and rights to access

information beyond what is provided to shareholders under applicable law.

Squeeze-out

Following a successful public takeover offer, a bidder who has not obtained 100% of the shares of the target can squeeze out the minority shareholders by means of a squeeze-out offer in order to obtain 100% of the share capital. A person holding 95% of the voting securities of a target can force all of the other holders of voting to sell their securities through a squeeze-out bid.

The squeeze-out procedure in a public takeover bid is subject to the following conditions:

- The bidder, either alone or in concert with others, must hold 95% of the share capital with voting rights and 95% of the voting securities after the takeover bid (or its reopening).
- The bidder must have acquired securities representing at least 90% of the share capital with voting rights to which the takeover bid applied through the acceptance of the bid. However, this 90% condition is not applicable if the bidder obtained the 95% ownership following a mandatory public takeover bid.

If these conditions for the squeeze-out are met, the takeover bid will be reopened at the same price. Securities that remain untendered to the bidder at the end of the reopened bid will be automatically deemed acquired by the bidder.

Debt Push-down

In Belgium, the two primary mechanisms for achieving a debt push-down are (i) the distribution of dividends or (ii) a reduction in capital, both financed through the incurring of debt (as applicable from a third-party provider or intragroup).

As a consequence of the debt push-down, the private equity-backed buyer, such as a newly established holding company, is able to promptly satisfy its acquisition financing debt, while the debt is transferred to the target company.

7.7 Irrevocable Commitments

An irrevocable commitment is a commitment made by a shareholder of a listed target to a bidder, in which the shareholder agrees to accept the bidder's offer once it is made. Irrevocable commitments allow bidders to have assurance that the securities will be tendered to them in the takeover bid, without directly purchasing the securities themselves. Under Belgian law, a security holder who accepted a bid during a takeover bid has the right to withdraw their acceptance at any time during the acceptance period.

It is worth noting that irrevocable commitments need to be carefully structured to comply with insider trading and market manipulation rules. This often requires the input of legal counsel with expertise in securities law.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentivisation of the management team is a common feature of PE transactions in Belgium. The rationale behind such incentivisation is twofold: (i) aligning the interests of the management team with those of the new shareholder and (ii) encouraging the management team to strive for the company's long-term success by granting them a share in the potential upside.

The specific level of equity ownership granted to the management team can vary considerably depending on factors such as the size and nature

of the company, the specifics of the transaction, the management team's contribution, and market norms. However, it is not uncommon for the management team's equity stake to be in the range of 2–30% of the company's equity.

8.2 Management Participation

Management participation in private equity transactions is sometimes structured to include an element of "sweet equity" to be allocated to the management. This structure is designed to incentivise management by giving them the opportunity to participate in the upside of the business if it performs well, against favourable acquisition terms.

Sweet equity refers to a portion of equity that is issued to the management team at a low value in consideration of their efforts in building up or improving the business. These shares can appreciate greatly in value if the company performs well, hence the term "sweet" equity.

Furthermore, while some deal structures will allow the managers to acquire shares in the buyout holding on closing, an alternative possibility is to issue stock options to management, which will allow them to acquire shares in the future.

Acquisition of Shares on Closing

A customary structure in the context of a PE transaction involves management acquiring shares upon the closing of the transaction. This is partly because the equity investment required for issuing these shares constitutes an integral part of the funding structure.

In the framework of a private equity investment, the holding company will sometimes issue two different types of shares: (i) preferred shares (also known as fixed-rate shares) and (ii) ordinary shares. Preferred shares yield a fixed per annum return to the holder, which is paid out prior to any dividend or liquidation payment to the ordinary shares. After this preferred return is distributed, any remaining dividend or exit proceeds will be allocated to the ordinary shares. Consequently, the preferred shares hold a senior rank compared to the ordinary shares, while the ordinary shares capture the upside value (referred to as "sweet equity"). Management might receive a greater proportion of ordinary shares compared to their preferred shares as an incentive, understanding that a higher exit valuation will lead to a greater return on the ordinary shares (thus making the equity even "sweeter").

Grant of Subscription Rights

An alternative way of setting op a management incentive programme could be by means of the issuance of subscription rights by the buyout holding.

Subscription rights provide their holders with the opportunity to acquire shares upon exercise in the future, at a predetermined price. Subscription rights can be exercised within a specified period and/or upon meeting certain performance targets. Usually, the subscription rights will only be exercisable in the event of an exit of the PE fund and the so acquired shares will be sold in the framework of said exit immediately, giving the managers a cash payment. The terms and conditions of the MIP subscription rights will be set forth in a subscription rights plan established by the board.

8.3 Vesting/Leaver Provisions

Manager-shareholders are usually crucial to the business. PE funds will therefore require such managers to remain active within the business until the occurrence of an exit.

A manager who leaves the company prior to the completion of an exit will be deemed a "good" or "bad" leaver, depending on the circumstances. An intermediary "early" leaver category is sometimes included as well. A leaver is forced to offer all or part of their shares for sale to another party, typically the PE fund or the company (who may reserve the right to allocate these shares to future managers).

Retirement or dismissal of the manager by the company (for reasons other than for cause) will typically be regarded as good leaver events. Voluntary resignation by the manager may, depending on the case, be a bad or early leaver event. In some cases, the shareholders' agreement will provide that a manager will be a good leaver if the termination occurs after a certain number of years.

In the case of a good leaver event, the beneficiary of the call option will typically have the right to acquire part or all of the manager's shares (depending on the inclusion of a vesting schedule) at fair market value. If a vesting schedule is included, it could have an impact on (i) the number of shares that the good leaver will need to offer for sale (limited to the unvested shares) or (ii) the price to be paid by the beneficiary of the call option upon exercise of the option (which could be the fair market value for vested shares and original subscription price for unvested shares).

In the case of a bad leaver event, the PE fund and/or the company typically have the right to acquire all shares (whether or not vested) at the lower of fair market value or the initial subscription price (sometimes after application of a discount).

8.4 Restrictions on Manager Shareholders

In Belgian private equity transactions, manager-shareholders typically agree to restrictive covenants, including non-compete, non-solicitation, and non-disparagement undertakings. These covenants, which aim to safeguard the company's interests during and after the manager's involvement, are often included in both the shareholders' agreement, as well as the service or employment agreement of the manager. With regard to non-compete clauses, the enforceability of these covenants hinges on their reasonableness and proportionality, and Belgian courts can modify or nullify any overly restrictive terms. To be valid under Belgian law, non-compete clauses must be limited in scope, duration, and region.

For the sake of completeness, it is worth noting that in certain instances, manager-shareholders could be bound by a commitment to remain actively involved for a determined period following an exit event.

8.5 Minority Protection for Manager Shareholders

Minority shareholder protection in Belgium is provided under the terms of (i) mandatory statutory provisions and (ii) a shareholders' agreement.

Examples of mandatory statutory protection include information rights and, if the minority shareholder(s) holds at least a certain stake, the right to convene a shareholders' meeting.

In addition to these statutory protections, the management's interests may, depending on the deal structure and the negotiation power, be further protected via the shareholders' agreement. Key provisions in these agreements can include:

- veto rights on approval of budget and crucial business decisions;
- director nomination rights;
- pro rata participation rights in the event of future issuances of securities (or catch-up rights following a rescue financing); and
- consultation on exit strategies.

Depending on deal size and complexity, veto or consultation rights are sometimes reserved to one of the managers, who is tasked with representing the views of the whole of the management body.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

A PE fund shall usually maintain substantial influence over its portfolio companies to protect its investment and minimise associated risks. Depending on the type of PE fund, the stake in the target, the level of influence shall depend on the circumstances and negotiated documents.

Typical provisions relating to control include:

- veto rights over crucial business decisions;
- director nomination rights;
- information rights, ensuring access to comprehensive and timely financial data, performance reports, and other key metrics necessary for effective oversight; and
- the initiation of an exit process.

9.2 Shareholder Liability

Under Belgian law, shareholders, including private equity funds, are in principle not liable for the actions of the companies in which they invest. This arises from the fact that companies are a legal entity separate from the shareholders, whereby the shareholders are in principle only liable for their contribution to the equity of the company.

However, a PE fund can under some circumstances still be held liable for portfolio companies. For instance, a shareholder who assume the role of a de facto director shall be subject to directors' liability within the framework of the Belgian rules on director's liability.

10. Exits

10.1 Types of Exit

Exit Strategies

The exit strategies most frequently employed by PE funds include (i) a management buyout backed by a third-party PE fund and (ii) private sale to a third-party industrial player. Exits through an IPO are of course not unseen, but are certainly not common in the Belgian market.

With a dual-track exit strategy, both the private sale option and an IPO strategy run simultaneously, so as to allow the PE fund to have alternative exit options as long as possible. Adding the refinancing of the target as another strategy, the dual track can be extended to a triple-track exit strategy, to retain even more options. As IPOs are not common in Belgium, dual or triple-track exit strategies are also rare.

Roll Over Upon Exit of a Portfolio Company

After the sale of a portfolio company to a third-party PE fund, the original PE fund might be willing to reinvest together with the new PE fund in the target.

10.2 Drag and Tag Rights

Drag-along and tag-along rights are standard clauses in shareholders' agreements concluded

in the context of the Belgian PE market. These are protective provisions designed to maintain the balance of power between majority and minority shareholders.

Drag-along rights allow majority shareholders to force minority shareholders to participate in the sale of a company and typically come into play when a third-party buyer offers to acquire 100% of the shares of a company. The threshold to trigger these rights varies but is often set at a value between (i) a simple majority, being 50% plus one share and (ii) 90% of the shares.

Tag-along rights protect minority shareholders by giving them the right to participate in a sale of shares to a third party at the same price per share and the same conditions as the selling shareholders. The tag-along rights are usually triggered in the case of a sale by a (majority) shareholder.

Even though those provisions are ubiquitous in the Belgian PE market, they are rarely used in practice, as most sales processes are organised jointly among all shareholders.

10.3 IPO

An IPO lock-up refers to a specific duration, usually ranging from 90 to 180 days, following an IPO, during which shares held by company insiders are restricted from being sold.

Upon the occurrence of an IPO, PE sellers in such cases typically agree to a lock-up period, which restricts them from selling their shares for a specified amount of time following the IPO. As an example, when Bpost Belgium launched its IPO in 2013, each of the company, the selling shareholder (CVC Funds), the Belgian State and SFPI/FPIM (the Belgian sovereign wealth fund) were expected to agree to lock-up arrangements of 180 days after the first day of trading of the shares.

Trends and Developments

Contributed by:
Luc Wynant and Koen Hoornaert
Van Olmen & Wynant

Van Olmen & Wynant is an independent law firm offering quality services in employment and corporate law and litigation, active since 1993. The firm has about 40 lawyers serving a wide range of business clients including growth companies, multinationals, public companies and government institutions. Van Olmen & Wynant has extensive experience advising both investment funds and managers in PE transactions, and has been the long-time advisor of prominent companies such as ING Private Equity and the (PE-backed) Dstny group. Based in Brussels, the firm enjoys outstanding international contacts with high-quality law firms across the globe.

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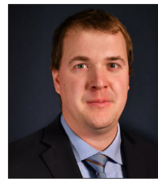

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BELGIUM TRENDS AND DEVELOPMENTS

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In 2023, global M&A volume fell to its lowest level in a decade, with the London Stock Exchange Group and Mergermarket reporting deal volume of USD2.9 trillion, down from USD3.5 trillion in 2022. The Belgian M&A market initially showed some resilience, but activity started to falter in the second half of 2022, particularly on large deals and private equity transactions.

The outlook appears brighter for 2024. Analysts are looking for an increase in deal activity, particularly on larger transactions exceeding EUR50 million, and among financial – rather than strategic – buyers, fuelled by abundant cash reserves and anticipated interest-rate cuts.

This article explores the trends and developments in the Belgian PE landscape for 2024, focusing on the impact on PE deal-making of:

- environmental, social, and governance (ESG) considerations;
- lengthening deal processes;
- the rise of alternative deal financing;
- increasing use of data analytics; and
- regulatory developments.

ESG Considerations

ESG considerations remained a prominent trend shaping the Belgian M&A markets throughout 2023. ESG matters have taken on increased importance in various deal-process phases, with more financial investors including them in their investment policies. ESG is seen as both a risk-assessment tool and value-creation driver. Belgian firms are increasingly prioritising sustainability and ethical practices in response to growing investor and consumer demands for responsible business conduct.

Despite challenges such as greenwashing and the use of incomplete and inconsistent data, the adoption of ESG in investment policies is gaining momentum. This highlights the need for relevant, structured, complete and consistent data. Greenwashing is the act of making false or misleading statements about a company's environmentally sound practices. To mitigate the risk of this, the EU has introduced several regulations and directives, including the Corporate Sustainability Reporting Directive (CSRD) and the Sustainable Finance Disclosure Regulation (SFDR). These measures aim to ensure the reliable integration of ESG matters into investment decisions.

ESG considerations vary in significance throughout the M&A process. According to respondents to the Vlerick 2024 M&A Monitor, ESG factors appear most critical during the initial stages, such as acquisition strategy development and target screening, and less relevant during the post-merger integration phase. Notably, ESG due diligence was conducted in approximately 19% of all deals, with larger transactions more likely to integrate these considerations. In 2024, achieving maximum deal value while balancing ESG considerations with other metrics will be of increasing importance for both sellers and purchasers.

Lengthening Deal Processes

The length of Belgian deal processes has increased, most likely due to a higher degree of market uncertainty and to regulatory complexities. This is forcing buyers to conduct extensive due diligence and to invest a greater effort in negotiations. Moreover, additional regulatory hurdles, such as the Corporate Sustainability Due Diligence Directive (CSDDD) and foreign direct investment (FDI), both discussed below, could draw out the deal-making process much further.

The extended timelines of Belgian M&A transactions could be said to reflect a strategic response to the evolving uncertainties and complexities of the market, highlighting the critical role of diligence and careful negotiation in navigating the shifting landscape of deal-making.

The Rise of Alternative Deal Financing

In M&A transactions, compared with strategic buyers, financial buyers tend to finance a higher proportion of deal prices with private debt – such as loans provided to companies by private funds rather than by banks. This trend is particularly pronounced in the smaller and mid-sized deal segments.

In 2023, the use of fixed (vendor loans) or performance-based (earn-outs) delayed payments remained quite stable. However, there was a significant increase in the use of vendor loans in the smaller and mid-sized deal segment. Additionally, in the smallest (less than EUR1 million) and largest deal segments, there was an increase in the proportion of transactions featuring an earn-out.

In 2024, high interest rates could keep private debt and vendor loans attractive, and encourage financial buyers to use more of their available cash reserves by increasing the share of the deal price made up of equity. However, expected interest-rate cuts could drive an increase in the recourse to debt.

Increasing Use of Data Analytics

Another emerging trend in the M&A market is the rising use of data analytics. Applying a variety of tools, technologies and processes, data analytics transfers raw data into useful insights that may help to identify trends and solve problems. Data analytics and AI technologies have become essential to the M&A landscape, offering numerous advantages throughout the deal process. Mostly applied during the initial phases, such as target screening, identification and due diligence, data analytics enables potential acquirers to gain insights into industry trends, examine target companies and identify potential synergies. During due diligence, data analytics facilitates a deep understanding and validation of crucial information, aiding in making informed acquisition decisions.

However, large amounts of pertinent data must be accessible in order to apply data analytics in M&A effectively. This remains a significant challenge, as the reliability of insights derived from data analytics hinges on the quality, consistency, accuracy and completeness of the data. The principle of "garbage in, garbage out" underscores the fact that data analytics is only valuable if based on reliable information. Additional challenges include a lack of expertise in data science, statistical analysis and domain knowledge, inadequate data technology infrastructure, high costs associated with implementing and maintaining data analytics systems and concerns about data privacy, security and compliance.

The EU has initiated some legislative efforts to address these challenges, such as the European Single Access Point (ESAP), providing centralised public access to information about companies and investment products at EU level. ESAP aims to increase transparency, accessibility and reliability, including ESG information.

While the full impact of data analytics on the Belgian market remains unclear, the potential for data-driven insights to transform various stages of an M&A transaction is undeniable. Advanced analytics and AI tools – employed by specialised

personnel – can empower decisionmakers, mitigate risks, and optimise strategies.

Regulatory Developments

Contract law

On 1 January 2023, Book 5 of the new Belgian Civil Code on contracts came into force. The new codification will have a significant impact on contracts involving or relating to companies. It is imperative to recognise the significance of these changes, as they affect various contractual agreements such as letters of intent, share purchase agreements, non-disclosure agreements, shareholder agreements, option agreements, and more.

It is also important to note that many of these provisions are supplementary law. If the parties wish to exclude these provisions in transaction documentation, they must expressly state this. This flexibility allows parties to negotiate and tailor their contractual terms to meet their specific needs and circumstances.

Additionally, on 1 January 2025, Book 6 of the new Belgian Civil Code addressing extra-contractual liability will also come into force. These new rules introduce a significant shift from the traditional prohibition against combining contractual and extra-contractual liability, potentially having a substantial impact on M&A transactions.

Corporate Sustainability Reporting Directive (CSRD)

The CSRD entered into force on 1 January 2024, creating a legal regime to address gaps in existing sustainability information regulations. Its goal is to ensure that financial markets have access to reliable, relevant, and comparable ESG information. Through transparent and standardised sustainability disclosure reporting, the CSRD aims to direct private capital towards funding the environmental and social transition. This enhanced disclosure framework has the potential to attract more investment and financing, supporting the transition to a sustainable economy in line with the Green Deal's objectives.

The implementation of the CSRD will introduce new reporting requirements for a wide range of companies, including those previously not covered under the Non-Financial Reporting Directive (NFRD). Compliance timelines vary: large public interest entities and companies already under the NFRD will start in 2025; other large companies in 2026; and listed SMEs in 2027. Non-EU companies with significant EU operations must comply by 2029.

EU Member States, including Belgium, have until 6 July 2024 to incorporate the CSRD into their national legal frameworks. A draft directive was sent to stakeholders for consultation in late December 2023. After the consultation period, the draft will proceed to parliamentary discussions for final approval. The implementation of the CSRD will ensure businesses provide comprehensive and standardised sustainability information, enabling investors and stakeholders to make informed decisions based on comparable data.

Corporate Sustainability Due Diligence Directive (CSDDD)

On 24 April 2024 the European Parliament and on 24 May 2024 the European Council formally adopted the CSDDD, obligating large EU and non-EU companies to identify, address and mitigate human rights and environmental effects within their operations and supply chains. This directive targets companies with over 1,000 employees and an annual turnover exceeding

EUR450 million, as well as non-EU companies with significant EU revenues.

The CSDDD requires active due diligence by companies to assess human rights risks and environmental risks in their value chain and to take necessary action to remedy these. Therefore, it is safe to say that this new directive takes the corporate social responsibilities of companies operating within the EU a step further. In order to have the directive approved, the scope of application was narrowed to EU companies employing at least 1,000 staff with an annual turnover exceeding EUR450 million, as well as non-EU companies operating within the EU meeting similar thresholds. Originally, the thresholds were 500 employees and turnover of EUR150 million, but these were deemed too low to convince enough member states to approve the proposal. Nonetheless, the CSDDD is still estimated to apply to over 5,000 companies and is welcomed by NGOs and human rights organisations.

The CSDDD will influence future private equity investment processes, prompting investors to prioritise their targets' ESG compliance. Also, it addresses not only the company but its entire supply chain, further affecting the due diligence process.

Foreign direct investment (FDI)

In 2023, Belgium introduced a screening mechanism to oversee foreign direct investments, safeguarding essential interests and preventing transactions that could jeopardise national security, public order or strategic interests. This screening mechanism applies to agreements entered into on or after 1 July 2023, which must be notified to the Belgian Interfederal Screening Commission (ISC) if they meet the relevant criteria.

The implementation of these FDI screening mechanisms in Belgium has led to increased regulatory oversight, longer deal timelines and increased overall complexity of the investment process. The FDI screening procedure can be time-consuming, with a 30-day deadline for reviewing the notification upon receipt of the file and a potentially extendable 28-day period for further screening. However, the process can be significantly prolonged if additional information is required or if corrective measures are negotiated.

As a result, private equity funds and legal advisors must incorporate the FDI screening provisions into their transactional documents. Compliance with this screening process is mandatory and suspensory, meaning that transactions cannot proceed until the necessary clearance is granted by the authorities.

Conclusion

In conclusion, the private equity industry in Belgium is expected to see a more favourable year across all deal segments in 2024.

Key trends, such as the increasing importance of ESG considerations, longer deal processes, the rise of alternative deal financing, and the growing use of data analytics will significantly influence deal-making strategies. Additionally, regulatory developments, including the CSRD, CSDDD, and FDI screening mechanisms, will play a crucial role in shaping the private equity segment. These factors collectively highlight the need for private equity funds and legal advisors to adapt to a dynamic and evolving market environment, ensuring compliance and optimising investment strategies to capitalise on emerging opportunities.

Although some uncertainty remains, transaction volumes are expected to rise in 2024. It will be very interesting to watch how financial buyers put their abundant cash reserves to work against a backdrop of falling interest rates, shaping the year's private equity landscape.

BRAZIL

Law and Practice

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TozziniFreire Advogados acts in 55 areas of corporate law and offers a unique structure, with 25 industry groups and four international desks staffed by lawyers who are considered experts in the market. With more than ten partners, TozziniFreire Advogados' strong private equity and venture capital practice has experience in fund formation, asset acquisition and portfolio structuring, as well as in a wide range of private equity transactional work. The firm's impressive track record extends across diverse industries that are particularly attractive to private equity investors in emerging markets, including infrastructure, real estate, retail, and technology. The firm has secured numerous mandates involving venture capital, private equity, and other alternative investments from prominent players such as Ontario Teachers' Pension Plan, Cadillac Fairview, Alberta Investment Management Corporation, the Canadian Pension Plan Investment Board, IG4, GEF Capital Partners, LGT Lightstone, MSW Capital, Greystar, FORS Capital (former Performa Investimentos), and Axxon Group.

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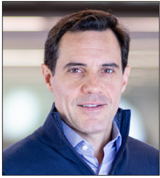

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

Following two remarkable years (2020 and 2021) for both private equity investments and exits in Brazil, in which the country accounted for approximately 48% of the total capital investments in Latin America in 2021 (according to data released by the Association for Private Capital Investment in Latin America, or LAVCA), private equity deal flow has decelerated significantly.

According to data released by TTR Data, the aggregate deal value and volume in Brazil declined in the second quarter of 2024 by 8.79% and 35.44%, respectively, compared with the same period in the preceding year. Nonetheless, according to data released by Mergemarket, in the first half of 2024, Brazil's M&A volume grew 66% YoY to USD18.7 billion.

The prevailing economic headwinds in Brazil, characterised by heightened inflation, fiscal and tax uncertainties, a weakened currency, and a projected slowdown in GDP growth from 2.9% in 2023 to 2.1% in 2024, are contributing to a more cautious investment climate. These factors are expected to prompt a slight decline in foreign investments in Brazil during the latter half of 2024, as investors adopt a more conservative stance.

The COVID-19 pandemic has undeniably reshaped the landscape of deal execution, necessitating a delicate balance between innovation and risk mitigation. This shift has prompted heightened efficiency in legal due diligence, with a marked emphasis on ESG considerations, compliance, and cybersecurity.

Local market practice has grown more receptive to pricing structures commonly adopted in other jurisdictions, such as the locked box and earn-outs, in addition to traditional completion accounts arrangements.

Last, but not least, the possibility of executing documents electronically has significantly streamlined signing and closing procedures. While social distancing has presented challenges (ie, difficulty in site visits and doing the groundwork that is sometimes crucial in an M&A process), clients and other advisers seem to have adjusted well to video conferences and remote meetings, which has helped make M&A processes more efficient.

1.2 Market Activity and Impact of Macro-Economic Factors

Alternative investments in infrastructure, venture capital, special situations, impact investing and private credit strategies have been particularly strong in the last couple of years. Traditional growth and development investment strategies in middle-market companies have remained steadily bullish (particularly where there is most competition for local assets).

In terms of sector focus, according to data from TTR Data, in the first semester in Latin America, transactions related to the technology and telecom sector represented the majority of PE/VC transactions (194), followed by industry-specific software (164), and real estate (95). Additionally, metal and mineral resources, distribution and retail, travel, hospitality and leisure, and power generation and electric utilities, have shown high numbers of deal value and volume.

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2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Social Security Reform

Constitutional Amendment No 103/2019, also known as the Social Security Reform (the "Reform"), changed the local social security system and is widely seen as an important measure to improve the government's fiscal health. One of the anticipated outcomes of this reform is the promotion of economic development by establishing a more predictable legal environment. This increased legal certainty is expected to bolster investor confidence, making Brazil a more attractive destination for foreign investment.

Almost five years after its approval in October 2019, the Reform is already well established. As part of the positive agenda to strengthen economic trust in the Brazilian government, the Reform is among the factors that have encouraged foreign investors to invest in Brazil.

Economic Freedom Law

Law No 13,874/2019, known as the Economic Freedom Law (the "Law"), came into force in 2019. The purpose of the Law is to create a more dynamic and liberal – and less bureaucratic – economic environment for doing business in Brazil.

The Law was designed to decrease intervention in the economy. As a means of achieving this, the law is based on the following main principles:

- freedom in economic activities;
- assumption of individuals' good faith before public authorities; and
- government intervention in economic activities must be secondary and exceptional.

The Law had a direct impact on the private equity marketplace, given the express provisions on limitation of liabilities afforded to onshore-fund shareholders. In December 2020, the Brazilian Securities and Exchange Commission (*Comissão de Valores Mobiliários*, or CVM) submitted a resolution proposal to public hearing, based on the framework introduced by the Economic Freedom Law. The purpose of these new regulations is to detail the limitations on liability for stakeholders of onshore funds. The new regulations also aim to:

- bring clearer definition to the issue of classes of shares by funds; and
- design a clear set of attributions of local general partners (GPs) and so-called administrators.

The Legal Framework for Start-ups and Innovative Entrepreneurship

The Legal Framework for Start-ups and Innovative Entrepreneurship, also known as *Marco Legal das Startups*, was published in June 2021 and aims to simplify the ecosystem for innovative companies, foster investment in innovation and facilitate the contracting of innovative solutions by the public sector.

The law serves as a first step in regulating the start-up market in the country. Mechanisms have been introduced to:

- incentivise investments;
- streamline business formation;
- simplify certain daily routines (eg, exemption from publication of financial statements and making it possible to use electronic corporate books for recording entries); and
- ease the process of contracting with government authorities/companies (by introducing regulatory sandboxes).

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Fiagro

Law 14,130/21, enacted in 2021, has introduced a new onshore-regulated fund type called Investment Funds in Agro-industrial Productive Chains (also known as "Fiagro"). It is a collective investment vehicle aimed at fostering private agribusiness financing.

There are three categories of Fiagro:

- Fiagro – Credit Rights;
- Fiagro – Real Estate; and
- Fiagro – Holdings.

GovTech Law

The GovTech Law (Law 14,129/2021) sets out principles, rules and legal instruments for the digital government. The aim is to reduce red tape, increase public efficiency and bring civilians closer to the Brazilian government through digital initiatives.

Despite the absence of direct regulation for investment funds, the Law covers a wide range of aspects of digital government, such as digital provision of public services, platforms of public government, and core principles such as transparency and access to data. Like other reforms, this might increase trust in the Brazilian economy and therefore make the country more attractive to foreign investors.

Business Environment Law

Law 14,195/21 ("Business Environment Law") was enacted in August 2021 and introduced, among other novelties:

- the possibility of issuing shares with weighted voting rights (dual-class structure) in corporations;
- easier mechanisms for opening companies;
- greater protection to minority shareholders;
- possibility for officers of corporations to be non-residents in Brazil; and
- the automatic conversion of individual limited liability companies (*Empresas Individuais de Responsabilidade Limitada*, or EIRELI) into individual limited liability companies (Ltda).

The Business Environment Law introduced several procedural changes aimed at streamlining the process of setting up companies, including merging federal, state and municipal tax registrations into the National Register of Legal Entities (CNPJ) and automatically granting permits and licences to companies with activities deemed medium risk, as well as other changes.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Private equity activities are not subject to any specific local regulations and/or restrictions. International private equity players with offshore structures can easily invest in and exit from assets located in Brazil, subject only to registering their investments with the Brazilian Central Bank. However, several laws and regulations may influence the practice as a whole.

Brazilian Securities Exchange Commission (CVM) Regulations

Onshore regulated funds are subject to specific regulations enacted by the CVM – for example, Instructions No 578/16 and 579/16, which provide for the general framework, accounting and valuation rules for the so-called FIPs (*fundos de investimento em participações*).

If anyone intends to act as a general partner in Brazil (ie, giving investment advice with regard to securities issued by Brazilian companies subject

to management fees and carried interest), this person (either an individual or a legal entity) must abide by certain requirements under asset management regulations issued by the CVM.

Public offerings are also subject to the CVM's scrutiny and applicable regulations.

In a nutshell, the CVM acts as a gatekeeper for certain activities that relate to the private equity environment in Brazil.

Other Regulations

Any foreign investors must register with the Brazilian Central Bank. In addition, they must enrol with the National Corporate Taxpayer Registry (CNPJ) and appoint a legal representative in Brazil before remitting funds.

Depending on the sectors targeted by private equity players, industry restrictions or certain government controls may apply, such as in energy, telecoms, broadcasting, aviation, oil and gas, insurance, transportation, sanitation, pharmaceuticals and financial services. For some of these industries, there are government agencies responsible for inspecting and regulating the services. Transactions involving change of control of companies operating in any segment of the local electrical energy market, for example, are subject to prior approval by the Brazilian National Electric Energy Agency (*Agência Nacional de Energia Elétrica*, or ANEEL).

CADE

If a transaction has effects in Brazil (ie, if the respective targeted investment derives, or is intended to derive, any turnover in Brazil), the respective parties involved in this transaction must assess if they meet the thresholds for mandatory clearance by the Brazilian antitrust authority (*Conselho Administrativo de Defesa Econômica*, or CADE) prior to completion.

This is a cumulative assessment if:

- one of the economic groups, on one side, has a Brazilian turnover equal to or in excess of BRL750 million; and
- the economic group, on the other side, has a Brazilian turnover equal to or in excess of BRL75 million.

This assessment is based on the analysis of the consolidated turnover of each economic group involved in opposite sides of the transaction and, pursuant to the rules issued by CADE, only investors with more than a 50% private equity fund structure will be taken into account for the purposes of this assessment. In addition, parties must verify if the intended investment would represent an acquisition of a 20% stake or more of the targeted business' total equity interest.

ESG

On 22 December 2021, CVM published Resolution No 59 ("CVM Resolution No 59/2021"), which is effective as of 2 January 2023. It aims to reduce the cost of regulatory compliance through the simplification and improvement of the informational obligations of securities issuers, including obligations to disclose information pertaining to ESG factors.

CVM Resolution No 59/2021 establishes that companies must state (in a "practice-or-explain" format) whether they disclose information about ESG indicators in an annual report or other specific document and, if so, indicate:

- the electronic address where such report or document will be publicly available;

- the methodology or standard followed in the preparation of such report or document;
- whether or not the report is audited or reviewed by an independent entity (and, if so, identifying the name of said entity);
- key ESG performance indicators and material indicators for the issuer;
- whether the report or document considers the Sustainable Development Goals (SDGs) established by the United Nations and, if so, which SDGs are relevant to the company's business;
- whether the report or document considers the recommendations of the Task Force on Climate Related Financial Disclosures (TCFD) or the financial disclosure recommendations of other recognised entities that are related to climate issues; and
- whether or not the company carries out inventories of greenhouse gas emissions, among others.

In addition, CVM Resolution No 59/2021 establishes a requirement for the provision of information regarding the diversity of the managers and employees of the company. It also requires the disclosure of information by hierarchical level, in the case of employees.

4. Due Diligence

4.1 General Information

As in any other jurisdiction, due diligence is a key part of the process towards completing any investment. It enables the investor to make an informed decision about key commercial elements of the investment and potential pitfalls, as well as ensuring that both the investor and sell-side are assessing the investment in good faith.

Local private equity players generally split the process into the following two phases.

- The first phase is generally focused on key aspects of the underlying business that would influence the investment team's decision regarding the feasibility of pursuing a given investment and placing an indicative offer (eg, if a company is heavily exposed to environmental issues, this phase would focus on potential red flags from an environmental law perspective).
- Phase two is generally a more extensive due diligence exercise that helps the private equity investor decide whether to place a final and binding offer. This phase should cover all areas of the law (to the extent applicable), namely:
  - (a) corporate law;
  - (b) financial obligations;
  - (c) commercial agreements;
  - (d) tax litigation (both in court and out of court);
  - (e) employment litigation (both in court and out of court);
  - (f) civil litigation (both in court and arbitrations);
  - (g) social security litigation;
  - (h) criminal law;
  - (i) compliance;
  - (j) intellectual property and information technology;
  - (k) cybersecurity and data protection;
  - (l) real estate;
  - (m) environmental law;
  - (n) regulatory;
  - (o) insurance; and
  - (p) antitrust.

Although the back-up materials prepared by a law firm are generally extensive, the output materials to a private equity investor consist of

a summary/risk matrix focused on key findings. These findings are related to:

- factors that would affect or delay the ability of the parties to complete the transaction (eg, third-party consents, corporate reorganisation to carve out assets, etc);
- issues that may affect the price (eg, liabilities that are more than likely to result in an obligation on the part of the target company to make a payment); and
- matters to be addressed through contractual provisions, such as representations and warranties, indemnification provisions and respective guarantees/collateral.

The due diligence exercise is generally handled through the analysis of documents, available on virtual platforms, by several specialists led by a core legal team that manages the flow of information, Q&As and interactions with other advisers and parties involved in the transaction. There are certain checkpoints, however, where the legal team is afforded access to key personnel of the target business, either to interview them based on their respective expertise or to gather information through management presentations.

Reviews done by law firms in Brazil are typically focused on legal issues that have already been reflected in investigations or claims, or which lack required documents and licences. Routine procedures and contingent liabilities are usually assessed by auditing/accounting firms, technical environmental experts, and/or compliance experts. The law firms are also in charge of assessing the risks in respect of findings identified in reports prepared by such technical experts. Therefore, a key element for a successful due diligence exercise is regular communication and collaboration between all advisers involved in the process.

4.2 Vendor Due Diligence

Vendor due diligence has become more common in Brazil as transactions are increasingly organised through private auctions, owing to the fierce competition for local assets (which, in turn, offers a reasonably interesting way for a private equity investor to maximise returns and gain momentum on the sell-side). The respective report generally contains a high-level review by external counsel to sell-side regarding specific critical matters and works as a shortcut for the review conducted by participants of the process. Depending on whether these vendor due diligence reports are issued on a non-reliance or a reliance basis, external counsel to the potential buyer would use its own due diligence exercise in order to validate, cross-check and go into deeper detail on the information included in these vendor due diligence reports or proceed to the so-called “top-up” due diligence.

5. Structure of Transactions

5.1 Structure of the Acquisition

The vast majority of transactions carried out by private equity funds in Brazil are equity transactions, completed upon execution of private investment or stock purchase agreements, either through a private auction sale or privately negotiated transaction.

Convertible debt arrangements have also become common, reflecting the growth in Brazil’s venture capital and CVC sectors.

In addition, the Brazilian Congress passed some material improvements to Brazil’s insolvency and recovery laws in 2020, which have further incentivised private credit and special situation funds to participate in auctions for “separate business units” (*unidades produtivas isoladas*) within

insolvency proceedings. These reforms provide winning bidders with a clearer separation from succession liabilities, creating a more attractive environment for investment.

5.2 Structure of the Buyer

As a general rule, private equity-backed buyers are either structured as:

- cross-border offshore funds (with the underlying vehicle that invests directly in Brazil domiciled in a jurisdiction that is not considered, for the purposes of Brazilian law, to be a tax haven – ie, jurisdictions that charge income tax at rates below 20%); or
- onshore regulated fund vehicles such as FIPs, FIIs (*fundos de investimento imobiliário*), FIMs (*fundos de investimento multimercado*), FIDICs (*fundos de investimento em direitos creditórios*) and the Fiagro.

Each of these onshore-regulated fund vehicles serves a specific purpose and offers some tax breaks and protections, provided that certain concentrations and other conditions are met. FIIs are intended for investments in real estate. FIMs are intended for investments in multiple classes of assets (including debt securities, equity securities, bonds, options, etc). FIDICs are aimed at investing in credit rights. The purpose of the recently conceived Fiagros is to invest in agricultural assets and businesses. Finally, the vast majority of purely private equity onshore vehicles are structured as FIPs, which can invest in shares of privately or publicly owned corporations, shares of limited liability companies (subject to certain conditions/thresholds), debt securities that are convertible into equity, and debentures (either convertible or not), both in Brazil and abroad.

It is fairly common for private equity funds to be directly involved in the execution of each respective deal documentation, unless there are any other particular strategic reasons for these players to invest through a local company. If the investment thesis of a certain fund is based on consolidation of local fragmented markets on acquisitions and add-ons, they would typically have a company underneath the fund to operate as the consolidating platform, either formed from the outset by the sponsor or acquired from a third party.

5.3 Funding Structure of Private Equity Transactions

Private equity deals executed in Brazil are typically funded through equity investment commitments.

Leveraged Buyouts

Leverage buyouts are scarce in Brazil as a result of:

- the scarcity of a sophisticated debt market – historically there has been little incentive for the development of products locally for a number of reasons (eg, hyper-inflation in the 1990s, volatility, risk aversion, financial markets heavily concentrated in a few local sponsors); and
- historically high interest rates (although this has been shifting over the past few years).

However, some international sponsors raise debt in other jurisdictions scattered across their fund structure, thereby bringing the proceeds into Brazil as committed equity.

Equity Commitment Letters

Equity commitment letters are common, especially in the context of cross-border deals where the underlying international investment fund

decides to channel the funds required to pay the purchase price through a newly incorporated local vehicle, or if a portion of the respective consideration is deferred. It is not unusual for these equity commitment letters to also be backed up by some type of collateral in Brazil. In the context of paying the purchase price in instalments, for example, the respective equity commitment letter may be backed by a pledge on the target's shares acquired by a private equity fund to the benefit of the sell-side.

Private Equity Players

The majority of local private equity players generally invest upon acquisition of substantial minority stakes in Brazilian businesses (25–49% stakes), with rights that effectively afford them a high level of influence in the respective companies invested in, in addition to strong exit/liquidity rights. Some also tend to negotiate options to buy control within a certain timeframe.

There are also a few more robust private equity players that usually focus on buyouts, including funds of international well-established private equity houses (such as Carlyle, Advent and others) and of Brazilian champions (eg, Patria and Vinci). However, there is more competition, given the scarcity of assets with this development profile in Brazil.

5.4 Multiple Investors

Deals involving a consortium of private sponsors are becoming increasingly popular, especially for venture capital. Brazil is following the same investment model for a series of investments that is typical in jurisdictions such as the USA. A more seasoned venture capital sponsor in Brazil generally takes the lead in a mix comprising a range of international and local sponsors and angel investors that would have a passive stake.

Co-investments are also becoming a trend in private equity, with two or more active private equity sponsors sharing leadership/control – especially in the case of companies in the later development stages. These are generally backed up by a separate relationship agreement establishing governance among co-investors.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Completion accounts are by far the most common pricing mechanism used in private equity transactions in Brazil. They are probably associated with a traditional buy-side aversion to taking risks before stepping into the cap table/management of the company, as the basis for the adjustment is generally financials drawn up closer to the completion date. Effective adjustments generally occur within a certain timeframe after completion.

Locked-box mechanisms have also become reasonably common over the years, especially in deals involving exits by private equity players. This means more predictability for the sell-side, as the price of locked-box mechanisms is usually only adjusted for post-closing disbursements qualified as leakage (pursuant to a clear definition under the respective transaction). Parties also negotiate items that would generally be expected to take place, which are defined as permitted leakage.

Deferred payments structured upon earn-out arrangements are also a useful tool for a private equity buyer, as they address uncertainties about future performance. This type of arrangement entails carefully crafted protections for both parties – especially when it comes to

defining the metrics used to assess whether the earn-out performance thresholds are triggered, thereby causing the buy-side to pay the respective deferred consideration. On the flip side, the sell-side would need to ensure that achieving the goal remains a feasible task should certain protective covenants and normalisation items be included.

6.2 Locked-Box Consideration Structures

Locked-box mechanisms are becoming more popular within private equity transactions, especially if the buyer is a private equity seller. Leakage is generally adjusted for a pre-determined ticker fee or inflation index.

6.3 Dispute Resolution for Consideration Structures

Except for transactions where parties agree upon a fixed price, there is always a dispute resolution procedure intended for sorting out parties' different views concerning the elements that may adjust the price. Usually one of the parties is responsible for sending out an initial calculation, while the other party is afforded the right to review and dispute the items that comprise the calculation. If parties enter a deadlock, the dispute should be submitted to a third-party expert (a neutral lawyer, auditor or appraiser, depending on how the pricing is structured). Names can be included in a list that parties negotiate and include in the respective transaction documents from the outset. This avoids lengthy and cumbersome discussions around the choice of expert.

Some more complex arrangements provide for the possibility of each party electing its own expert and then a third (neutral) one being appointed if the deadlock persists. However, these complex mechanisms have proved inefficient and time-consuming – and generally achieve the same end result as a mechanism where parties appoint an expert from a pre-agreed list.

6.4 Conditionality in Acquisition Documentation

Conditionality is generally based on the requirement to submit a transaction to government authority approval (such as the local antitrust authority, if parties to the transaction fall in any of the thresholds described in **3.1 Primary Regulators and Regulatory Issues**, or – depending on the sector – a regulator). Third-party approval is also common, especially considering that most financing arrangements provide for change-of-control provisions; going ahead with a transaction without waiver by the respective sponsor may result in early maturity and cross-default of financings. Other conditions, such as a reorganisation for carving out certain business/assets, may apply. There are still several family-owned businesses in Brazil, for example, and, title to some assets may therefore need to change hands prior to completing a transaction (eg, the intellectual property that is required to operate a business that is unduly registered in the name of a shareholder).

If a deal is subject to conditions for completion (ie, there is a delay between signing and closing), the parties would usually negotiate the terms and conditions of a material adverse change condition – especially if the respective delay is material. Although these provisions may be as broad as the parties agree upon, it is generally better to include certain tangible boundaries in order to provide deal certainty. One example would be the ability of a material adverse change to cause a loss that is substantially higher than the normal course (above a certain percentage or even absolute number).

6.5 "Hell or High Water" Undertakings

"Hell or high water" is generally acceptable, to a certain degree, if:

- the only condition to completion of a deal is antitrust clearance in Brazil that is eligible for the so-called fast track procedure (*rito sumario*); and
- the respective private equity buyer has no prior investments in companies exercising dominant positions in a given market.

This is because private equity investors executing deals in Brazil focus on deal certainty. Nonetheless, parties generally agree upon certain tangible boundaries, such as commitments imposed on any of them by the authorities for selling non-core businesses or businesses representing less than a certain percentage of their revenues.

6.6 Break Fees

Break fees have become common, especially in the context of a seller deciding to run a private auction to dispose of the target. These provisions can be structured with a compensatory nature for direct and indirect losses, but they are generally intended to cover parties' expenses with external advisers and costs incurred from the analysis of a given transaction.

6.7 Termination Rights in Acquisition Documentation

A private equity buyer would typically have the right to terminate an acquisition agreement if:

- closing has not occurred within a certain timeframe agreed by the parties in the transaction documents, which set out a maximum time limit for closing (the so-called long-stop date);
- on closing, sell-side is not capable of bringing down the representations and warranties given on signing;
- any conditions are not fulfilled within the pre-established timeframe; and
- there is a material adverse change in the business.

6.8 Allocation of Risk

In transactions where a private equity fund is the seller, the desirable outcome is to achieve a clean break, meaning that substantially all liabilities associated with the acquired business would be transferred to the buyer, regardless of whether they relate to the period before or after closing. This is because private equity funds often try to ensure certainty on amounts of return distributions across the waterfall for limited partners and carry payments to general partners. Therefore, the structure put forward (at least as an initial position) is to offer buyer-limited indemnification rights, primarily focused on the breach of fundamental warranties and contractual provisions, with no indemnification for issues disclosed during the due diligence or under the representations and warranties given in the respective transaction documents.

However, considering some of the risks typically involved in Brazilian businesses (chief danger zones are generally tax and labour issues, but also environmental matters, if the target is exposed to activities that may impact the environment), the general clean-break approach might be tempered by exceptions. This is probably one of the main reasons why most funds dedicated to investing in Brazil provide for an additional term of three years for drawdowns by limited partners, with the intent of making the sell-side whole for any indemnification obligations.

The customary risk allocation structure, however, is known as "your watch, our watch". This structure considers limitations imposed by the asymmetry of information between buyer and seller prior to completion of a transaction, and also takes into account time constraints imposed by fierce competition for the best assets. Based on this structure, a buyer gets full indemnity for all matters preceding closing (regardless of their disclosure) – assuming that the deal value was established on the understanding that the target business had no exposure to liabilities that could potentially generate losses. This also helps to maximise gains for the sell-side, as some matters would potentially generate an obligation to make a payment (hence reducing consideration) upon materialisation. These obligations are generally subject to some limitations, including:

- indemnification cap amount;
- time limits on placing a claim for indemnification, which generally vary depending on the statute of limitation of each matter;
- de minimis, which is an exclusion of minor amounts related to matters that are part of the recurring business (eg, employment liabilities up to a certain amount);
- deductible amount, which is a "cushion" or a discount on sell-side obligations to indemnify;
- exclusion of loss of profits, moral damages, loss of business opportunities and other indirect losses from the concept of what should be construed as an indemnifiable loss;
- a tipping basket, which is a management account wherein potential losses may be recorded and subject to indemnification (from dollar one) when it exceeds a certain threshold;
- no double recovery for same loss;
- duty of the buyer to mitigate losses;
- exclusion of matters that are already forecast and provided for in the financial statements, based on records in certain reserves (generally not funded); and
- exclusion of losses covered by insurance.

These indemnification obligations are generally backed up by some type of guarantee/collateral, as detailed in **6.10 Other Protections in Acquisition Documentation**.

In the venture capital space, local practice is constantly aligning with international standards, with investors seeking less aggressive indemnification rights. This represents a notable shift, even considering the historically risk-averse tendencies of investors in the Brazilian market.

6.9 Warranty and Indemnity Protection

Usually, private equity sellers try to limit their representation and warranties to typical fundamental warranties (ownership of shares, capacity, authority, etc). On the flip side, if the private equity seller is a buyout fund (ie, with a greater level of influence on the business), it is common practice for the fund to give mainly the same warranties as other shareholders, who tend to rely upon warranties given by management shareholders. However, under no circumstance will the fund accept being bound by joint and several liability with other shareholders, as this may be construed as a means of giving collateral for the benefit of third parties. As described in **6.8 Allocation of Risk**, if a private equity fund is the seller, it has become acceptable in Brazil for the parties to agree on a clean break, with full (fair) disclosure of the data room against the warranties. Limitations are substantially the same as detailed above, including potential qualifications on warranties (knowledge, ordinary course, materiality, etc). However, in the context of a deal structured under a clean-break arrangement, a buyer would seek to include anti-sandbagging protections in the transaction documents.

6.10 Other Protections in Acquisition Documentation

Additional protections include collateral (pledge, fiduciary transfer, etc), personal/parent guarantees and other types of liquid guarantees such as escrow accounts and hold-backs. Warranty and indemnity (W&I) insurance has been used in only a few deals in Brazil (particularly in the context of acquisitions of assets operated under concession to public services). Brazil's insurance market is small and only a few operators actually offer W&I insurance.

6.11 Commonly Litigated Provisions

In most cases, disputes in connection with private equity transactions relate to earn-out consideration payments, indemnification payments/assessments, enforcement of collateral, material adverse change provisions and conduct of business in the ordinary course between signing and closing. These disputes are generally resolved under arbitration based in Brazil and governed by Brazilian law if the asset is located inside the country, as enforcement of court decisions and arbitral awards issued overseas depends on confirmation by the Brazilian Superior Court of Justice (*Superior Tribunal de Justiça*). This confirmation process is subject to certain legal requirements, and it is not possible to ensure that confirmation will be achieved or provide timing estimates for conclusion.

7. Takeovers

7.1 Public-to-Private

Public-to-private transactions account for a minor portion of the local deal flow (especially within the local private equity environment), considering the relatively small size of the local public equities market compared with jurisdictions like the US and the UK. Brazil is now entering a cycle that probably precedes these types of deals, where private equity players start performing exits via IPOs.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Material shareholding positions in public companies are subject to the following disclosure and filing obligations established by the CVM.

- Any shareholder or group of shareholders acting together or representing the same interest must notify the public company immediately after any transaction that causes such shareholder or group of shareholders to cross – upwards or downwards – the thresholds of 5%, 10%, 15% (and so on) of a type or class of shares of such public company.
- During a mandatory tender offer for the acquisition of control of a public company, any shareholder or group of shareholders acting together (or representing the same interest) holding 2.5% or more of a certain type or class of shares must inform the market of any direct or indirect 1% variation (upwards or downwards) in its shareholding.

7.3 Mandatory Offer Thresholds

Mandatory tender offers are applicable to public companies only and are triggered in the following circumstances:

- after the controlling shareholder of the public company or a person related to it acquires shares representing more than one-third of the total shares of each type and class;
- upon the sale of the public company's control (in which case, the tender offer is a condition precedent to the completion of such sale); or
- for delisting the shares of the company (in which case, the tender offer is a condition precedent to delisting).

7.4 Consideration

Cash is by far the most typical type of consideration. However, share deals are common where the intention is to consolidate fragmented markets – in such case, sellers receive shares of the consolidating entity as consideration for their stake. Other types of arrangement may apply, especially in the venture capital arena, where Brazilian entities are flipped over to Delaware/Cayman entities and sellers receive convertible notes or other types of securities of these entities as consideration.

7.5 Conditions in Takeovers

Voluntary or mandatory tender offers to acquire shares of public companies in Brazil are subject to CVM Resolution No 85/2022, which establishes that the tender offer shall:

- be directed to all the holders of shares of the same type and class as those that are the object of the offer without distinction;
- ensure the equitable treatment of all recipients of the offer, furnishing them with adequate information about the company and the bidder;
- be intermediated by a brokerage firm, securities dealer or financial institution with an investment portfolio;
- be launched at a sole price, except where it is possible to set different prices according to the class and type of shares subject to the tender offer; and
- be carried out in an auction on a stock exchange or over-the-counter market.

Furthermore, the bidder can subject the tender offer to conditions, provided that such conditions do not directly or indirectly depend on any action by the bidder or its related parties. Takeover offers in connection with privately held companies are not subject to specific regulation and may be more freely negotiated.

7.6 Acquiring Less Than 100%

Even if a bidder does not seek or obtain 100% ownership of a target, it might have vast governance rights over a Brazilian corporation depending on its interest ownership. Such governance rights arise from the fact that, in general, resolutions are approved by majority votes cast in the shareholders' meeting. However, certain resolutions depend on a higher approval quorum, as established by the Brazilian corporations' law. The by-laws can also establish higher quorums.

Additionally, in a case where shareholders representing at least 10% of the voting stock request multiple voting rights for the election of the members of the board of directors (ie, a system by which each share will hold as many votes as director positions to be filled and the shareholders will be entitled to allocate their votes among candidates as they choose), the shareholder (or group of shareholders) holding more than 50% of the voting stock will have the right to elect the number of directors elected by other shareholders (plus one).

Squeeze-Out Mechanisms

Brazilian law does not provide many possibilities to squeeze out minority shareholders, except in the case of a tender offer to delist the company. In this case, if less than 5% of the total shares issued by the company remain outstanding after the completion of the tender offer, such shares may be redeemed (squeezed out) for the same price per share as the tender offer, provided that the bidder deposits the amount in a financial institution authorised by the CVM, where the amount shall be at the disposal of the remaining shareholders.

7.7 Irrevocable Commitments

As opposed to other jurisdictions with consolidated equities markets such as the USA and the UK, where unconditional undertakings are common and even regulated to some extent (eg, by the UK Takeover Code), this is unusual in the context of Brazilian public M&A. This is mainly because there are very few Brazilian listed companies with dispersed control, which is where these undertakings generally come into play. In the context of private M&A, any investment by a private equity player is negotiated in advance with other shareholders, who then cast their votes in a manner that ensures the transaction will be completed – at least from a corporate governance standpoint.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentive plans are a key feature of any private equity transaction executed in Brazil. These incentive plans can be structured as profit-sharing arrangements, stock option plans or phantom stock plans, in addition to traditional earn-out arrangements where the selling founders of a business head up business operations as C-level executives. Normal dilution in the private equity sphere would be up to 5%, whereas this can be higher in the seed/venture capital stage (up to 10%).

8.2 Management Participation

Management is usually key in the context of a private equity transaction and incentive arrangements are one of the fundamental portions of an investment package offered by a private equity investor. These incentives can either be based on the right to receive additional upside in a liquidity event, shares given from the outset, or other types of arrangements. Types of securities taken up by management also vary. Preferred instruments can be:

- a feasible solution such as preferred stock affording the respective beneficial owners a larger share of the economic benefits (through preferred/minimum dividends);
- liquidation preference (which is junior to the liquidation preference given to the private equity investor); and/or
- redemption rights.

8.3 Vesting/Leaver Provisions

Vesting is generally based on both retention for a minimum period of time and certain performance goals. This may include ramp-up triggers over time, provided that certain goals are achieved. All these mechanisms are generally backed up by “good leaver/bad leaver” provisions.

“Good leaver” provisions relate to situations where the respective management shareholder leaves their office in management as a result of circumstances that are beyond their control (eg, death, disability, or dismissal for no reasonable grounds).

“Bad leaver” provisions are the opposite – that is, they concern situations where:

- there is a just cause for dismissal (such as wilful misconduct);
- the manager shareholder leaves before the agreed-upon minimum retention/lock-up term; or
- the manager shareholder decides to move to a competitor.

8.4 Restrictions on Manager Shareholders

Typical key restrictive provisions for manager shareholders are non-compete and non-solici-

tation provisions within a limited territory, scope and term (maximum of five years), provided that there is reasonable consideration for such obligations. Non-disparagement, "key-person" and confidentiality provisions are also common, although assessment of compliance by manager shareholders with these obligations can prove difficult in practice, as enforcement relies on strong evidence. All these obligations are generally backed up by non-compensatory penalties.

8.5 Minority Protection for Manager Shareholders

Manager shareholders generally benefit from certain restrictions on:

- transfers of shares (typically pro rata tag-along rights, although in some circumstances they can benefit from rights of first offer/first refusal if they remain as "material" manager shareholders);
- the issue of shares (pre-emptive rights, which are statutory pursuant to Brazilian law);
- information rights;
- veto on transformation of the corporate type;
- minimum mandatory dividend; and
- some other rights that may result in them exiting the company with proper compensation pursuant to the law – the so-called "withdrawal right" – if certain decisions related to the structure, purpose and existence of the company are passed without their favourable vote.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

A private equity buyer generally exercises some level of control in their investments in Brazil, where there is a statutory obligation for the investor to exercise effective influence (*influencia efetiva*) on the portfolio company's decision-making process. This is especially true if the respective investment vehicle is structured as a FIP. In addition to protections against value destruction (eg, vetoes, negative covenants and reserved matters that require a super-majority in order to be approved), a private equity buyer would generally require that all shareholders enter into a shareholders' agreement that ensures the private equity investor:

- rights to appoint at least a board member (and, in some cases, an observer too);
- clear process for appointing other officers, based on goals;
- support from external experts (such as a head-hunter firm) when choosing professionals in the market;
- the right to appoint a C-level officer (generally the CFO) in the case of higher-interest ownership; and
- information rights within pre-established seasonality and level of detail.

Among other provisions, the shareholders' agreement would also include clear governance provisions, such as:

- rules for convening board and shareholders' meetings;
- requirement that the financial statements are audited by an authorised external firm;
- clear process for scrutiny of related-party transactions;
- prohibition on the issue of founders' shares (*partes beneficiárias*); and
- jurisdiction of an arbitration panel for the resolution of disputes among the shareholders.

9.2 Shareholder Liability

Brazilian law generally provides for separation of liability between shareholders and the respective Brazilian invested companies, with a few exceptions outlined in:

- the Brazilian Civil Code, which provides the general framework for piercing the corporate veil in the case of fraud or abuses;
- the Consolidated Labour Act, which introduces a notion of liability for all entities belonging to an "economic group" for the labour debts of the underlying entity that is in default;
- the Brazilian Consumers' Code, which is also based on evidence of conduct, in a similar way to the mechanism of piercing the corporate veil set out in the Brazilian Civil Code;
- the Brazilian Environmental Crimes Act (if there is evidence that a given company serves as an obstacle for the reparation of damages caused to the quality of the environment); and
- the National Tax Code, which provides that personal liability for tax debts can extend to company shareholders, officers, managers and administrators that act with excess powers or in violation of the law.

However, depending on how the investments are structured, there are several ways of mitigating these risks.

10. Exits

10.1 Types of Exit

The holding period depends on the type of strategy of the private equity fund, the maturity and sector of the invested companies, and the level of returns accrued by these companies vis-à-vis the fund's hurdle. As a general rule, pure private equity funds generally tend to hold their investments between five and ten years.

Common Private Equity Exits

Sales to strategic buyers or institutional investors and/or secondary buyouts to private equity funds continue to account for the vast majority of the exits executed in Brazil. However, IPOs have also come back strongly as a realistic means of exiting, as they offer promising returns to private equity investors. With Brazil's benchmark interest rate at its lowest-ever level, investors have sought to diversify their traditional fixed-income strategies, turning to the Brazilian capital markets. According to data released by LAVCA in 2020, 13 Brazilian companies backed by private equity funds made their debut in the public markets. Although the market has grown more selective in 2021, the pace of IPOs remains steady.

Dual tracks

Dual tracks are also becoming increasingly popular. Despite the spike in the number of exits through IPOs, Brazil's capital markets continue to be shakier in comparison with developed jurisdictions, given the country's exposure to global markets. A means of streamlining uncertainties around the IPO process is to conduct an IPO while also pursuing a possible M&A through a private auction process. This was especially noticeable among companies that started their IPO processes and were unable to capture their desired market caps during a relative downturn in the Brazilian capital market in the fourth quarter of 2020 and the first quarter of 2021. Some companies that had made their first IPO filings with the CVM eventually cancelled their offer requests and reportedly turned to private buyers.

Drawdowns

Private equity investors typically do not reinvest in the same asset after performing an exit. However, most onshore funds or offshore funds with a Brazil-focused strategy provide for an additional term of up to three years after an exit for drawdowns for making buyers whole under indemnification obligations.

10.2 Drag and Tag Rights

Regardless of the equity stake that they wish to acquire, private equity investors always request to be backed up by exit/liquidity mechanisms and protections, including drag-along rights. There is neither a particular threshold that would entitle a private equity investor to a drag right, nor a limitation on co-investors that could also benefit from it. However, generally there is some definition of who could call a drag if there is a clear leading investor in a series round, club deal or co-investment. It is common practice, though, that the ability of a private equity investor to exercise its drag rights is subject to certain boundaries, such as:

- a minimum time for this right to become effective, which generally matches the expected holding period and mirrors manager shareholders' lock-up obligations); and/or
- a trigger at a minimum pre-established valuation (based on a determined multiple of EBITDA, the target internal rate of return, etc).

Private equity players generally use this mechanism as a "stick" for seeking alignment by other shareholders toward a liquidity event. It turns out that it has seldom been enforced in practice, as parties eventually settle upon performing the exit desired by the private equity investor or the exercise of rights of first offer/first refusal by the other shareholders. It serves more as a protective provision than as an effective means of exiting.

The most common tag-along mechanics provide that:

- in the case of the sale of control by the manager shareholder, the private equity investor would have a tag-along right in relation to the totality of its stake; and
- in the case of a partial sale by the manager shareholder, the private equity investor would have pro-rata tag-along rights.

However, in venture capital investments and sectors where some liquidity needs to be afforded to the founding shareholders, it is not unusual for the manager shareholder to have pro-rata tag-along rights on a sale by the private equity investor.

10.3 IPO

CVM Instruction No 80/2022 establishes a lock-up for the controlling shareholders, the selling shareholders, company management, underwriters and other persons involved in the offer until the IPO closing announcement (*anúncio de encerramento*) is published. However, it is common practice in Brazil for underwriters to request that the controlling and selling shareholders be bound to a lock-up for at least 180 days following the date of the IPO. This may vary from a more restrictive covenant – in which underwriters demand longer lock-up periods and establish certain milestones for releasing shareholders over time – to a more flexible covenant, where certain types of shareholders can be released from such obligation (including, in a few cases, funds of private equity sponsors that held minority stakes pre-IPO).

The execution of "relationship agreements" is not unusual in the Brazilian IPO environment.

Trends and Developments

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TozziniFreire Advogados acts in 55 areas of corporate law and offers a unique structure, with 25 industry groups and four international desks staffed by lawyers who are considered experts in the market. With more than ten partners, TozziniFreire Advogados' strong private equity and venture capital practice has experience in fund formation, asset acquisition and portfolio structuring, as well as in a wide range of private equity transactional work. The firm's impressive track record extends across diverse industries that are particularly attractive to private equity investors in emerging markets, including infrastructure, real estate, retail, and technology. The firm has secured numerous mandates involving venture capital, private equity, and other alternative investments from prominent players such as Ontario Teachers' Pension Plan, Cadillac Fairview, Alberta Investment Management Corporation, the Canadian Pension Plan Investment Board, IG4, GEF Capital Partners, LGT Lightstone, MSW Capital, Greystar, FORS Capital (former Performa Investimentos), and Axxon Group.

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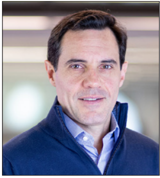

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BRAZIL TRENDS AND DEVELOPMENTS

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Economic and Political Outlook

Even though Brazil's GDP grew 2.9% in 2023 in comparison with the previous year (2022), the country's growth for 2024 is expected to slow substantially. Rising inflation, disputes between the government and the Brazilian Central Bank, municipal elections, the continuing war in Ukraine, the flood in Rio Grande do Sul, and tighter financial conditions have battered the Brazilian economic sentiment and the population's purchasing power, which adversely affected domestic demand in the first half of 2024. Also, discussions on government expenditures and the review of Brazilian tax laws added uncertainty and played a role in keeping investments restrained until 2024.

Deal Activity

Landscape in the first half of 2024

In the second quarter of 2024, the number of transactions has decreased by approximately 35.51% in Latin America in comparison with the same period of 2023; as such, the total aggregate amount related to transactional activity has decreased by approximately 31.26%, according to the Transaction Track Record's LATAM 2Q 2024 Quarterly Report.

Despite this regional downturn, Brazil bucked the trend, maintaining its position as the most active market for transactional activity in Latin America, encompassing M&A, private equity, venture capital, and asset acquisitions.

Although Brazil experienced a 35.44% decrease in the number of transactions, mirroring the broader Latin American trend, the total aggregate value decreased by only 8.79% compared to 2023. This suggests a shift towards higher-value transactions, particularly in asset acquisitions, as highlighted in the Transaction Track Record's Brazil 2Q 2024 Quarterly Report.

A retrospective analysis of the past year reveals a prevailing downward trajectory in both the number of transactions and their total aggregate value. M&A activity in Brazil spans a diverse range of sectors, including retail, food and beverage, industrial, healthcare, education, agribusiness, IT services, oil and gas, and technology (financial technology, agricultural technology, education technology, and healthcare technology).

The internet, software, and IT services sector emerged as the most active, accounting for 159 transactions in Brazil up to the end of June, representing 46% of the total. This was followed by the real estate sector with 73 transactions (21%), and the industry-specific software and business and professional support sectors, with 19% and 14%, respectively, according to the Transaction Track Record's Brazil 2Q 2024 Quarterly Report.

In the equity capital markets, no IPOs were registered, however, there was a notable increase in follow-on investments.

Foreign investors

US-based companies and investors continue to be the most active among foreign investors in Brazil. In addition to the USA, foreign investors from other relevant jurisdictions include the UK, Singapore, Spain, Canada, Germany, Argentina, Japan, Portugal, and Israel.

Predictions for the second half of 2024

Despite the economic headwinds anticipated for the year, notably the rise in interest rates, Brazil continues to present a compelling investment landscape and holds great potential for business expansion.

Investors remain focused on long-term growth, which – in the current landscape – means preserving resources and being mindful of the risks.

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With investors becoming more risk-averse, companies are reviewing their plans (including postponing acquisitions and IPOs).

Interest rates will also have an impact on the valuation of companies, with some discrepancies between the expectations of sellers and buyers. Some sellers and companies hope to keep attracting similarly lavish 2020–21 valuation metrics, whereas buyers have adjusted to a more conservative landscape.

Private equity, venture capital, CVC

Investments from private equity and venture capital funds in Brazilian companies exceeded BRL4,551 million in the first half of 2024, which is significantly lower than the amount invested in the same period of 2023 (BRL14,413 million). Beyond the tech industry, investors have been eyeing opportunities in traditional sectors, such as distribution and retail for private equity investors, and healthcare and consumer products and services for venture capital and CVC investors.

Although early-stage financing rounds have been less affected by stricter funding conditions than later rounds, valuations have also been adjusted downward and companies are rationalising operations to reduce expenditures in an attempt to postpone the need for new cash from investors. On the other hand, more Brazilian corporations are betting on corporate venture capital (CVC) programmes to invest in start-ups.

A preliminary study by the Brazilian Private Equity and Venture Capital Association (ABVCAP), carried out in 2023 among 35 companies of different sizes and structure, shows that 47% of such companies have a positive perspective regarding the conditions for CVC in Brazil, while 42% have a neutral perspective, and only 11% have a negative perspective.

Transactions in the technology sector remain among the most numerous. Other leading areas of interest in the first half of 2024 include: financial services (mostly fintech), distribution and retail (including e-commerce businesses), banking and investment, education and training services, transportation and logistics, healthcare, and consumer products and services. Transactions in such industries have been the most sought after in the past five years.

Acquihires, whether by venture capital- or private equity-backed companies or corporations with CVC programmes, remain very common – especially in the technology sector. Additional features of these transactions usually include stock options in the acquirer, plus earn-outs and enhanced non-competes in the deal's structuring.

Regulatory and Legal Framework Trends

Business Environment Improvement Law

The Business Environment Improvement Law (Law 14195/2021), enacted in the second half of 2021, introduced the following relevant changes to entrepreneurship and corporate governance of Brazilian companies.

Incorporation of businesses

The new law significantly reduced the bureaucracy for opening new businesses in Brazil by streamlining the process of opening new businesses and making it easier to obtain licenses and permits for the operation of new entities.

Plural vote

Both common and preferred shares in any corporation may, subject to certain rules, be of one or more classes (as opposed to the previous restriction that only preferred shares could have more than one class). Also, common shares of different classes can now have plural voting

rights (up to a limit of ten votes per common share). The amendment of the by-laws to regulate such rights requires the agreement of all holders of the affected shares.

In the case of publicly held corporations, the granting of plural voting rights must occur prior to the trading of the company's shares on organised securities markets, whereby the maintenance of more than one class of common shares is prohibited, except for the adoption of the plural vote. As a rule, the creation of a class of common shares with plural voting requires the affirmative vote of shareholders representing:

- at least half of the shares with voting rights; and
- at least half of the preferred shares without voting rights or with restricted voting rights issued at a specially convened meeting.

The incorporation and/or merger of publicly held companies, which are traded on an organised market and do not adopt plural voting, by a company that adopts plural voting is not allowed by the new law.

Developments of the Economic Freedom Act

On 20 September 2019, the Brazilian Federal Government enacted Federal Law No 13,874 (the "Economic Freedom Act"). This established the Declaration of Economic Freedom Rights, with the intention of stimulating economic activity by reducing government intervention in private activity.

The Economic Freedom Act inserted a new chapter on investment funds into the Brazilian Civil Code that endorses the jurisdiction of the Securities and Exchange Commission (*Comissão de Valores Mobiliários* or CVM) to regulate such funds. The new rules allow funds to establish quota classes of distinct rights and obligations, making it possible to set up separate assets for each class and – most importantly – limiting the liability of each owner to the value of their shares.

Finally, the Economic Freedom Act extinguishes the liability of fiduciary service providers for legal and contractual obligations under the funds' by-laws, except in the case of wilful misconduct or bad faith.

Changes in corporate regulations resulting from the pandemic

In response to the challenges posed by the outbreak of the COVID-19 pandemic in April 2020, regulations were introduced to ease various requirements for corporations and limited liability companies.

Among those changes was the opportunity to conduct shareholders', quotaholders' and associates' meetings – fully or in part – by electronic means, with rules similar to those for in-person meetings. Digital filings of corporate documents are also now a reality for most states and cases.

Although subject to debate, recent regulations also related to the issuance of preferred quotas by limited liability companies and the transformation of associations (largely used in the health and sports sectors) into companies.

Start-up bill

In June 2021, Congress enacted a start-up bill (*Marco Legal das Startups*) aimed at reducing bureaucratic obstacles for start-ups and strengthening legal security for those looking to invest. From the entrepreneurs' perspective, the expectation is that start-ups will be able to operate and close deals at lower cost and with fewer restrictions. From the investors' side, the

chances of being held liable for events that are typically associated with investing in a start-up (eg, debt) are also drastically reduced.

Restructuring and insolvency reform

Among other developments, the new Brazilian Bankruptcy Law sets out that UPIs (isolated productive units) will be free and clear of any liability. Additionally, there will be no succession of the bidder in the debtor's obligations, including – but not limited to – those of an environmental, regulatory, administrative, criminal, anti-corruption, tax and labour nature. Furthermore, contracts and obligations arising from co-operative acts performed by co-operative societies with their members are not subject to the effects of judicial reorganisation.

New offering procedures

The Brazilian Securities Commission (CVM) issued a new regulation (Resolution 160) on 13 July 2022, which aimed to increase flexibility and therefore facilitate the procedures for offerings in Brazil. This regulation was effective as of 2 January 2023.

Resolution 160 removed the existing division between registered offerings (the old CVM Rule 400) and offerings not subject to registration (old CVM Rule 476).

According to the new regulation, all public offerings destined to Brazilian investors (resident, domiciled or established) should be subject to a registration process. There is, however, a distinction in the procedure depending on the format chosen for the offering. Resolution 160 is now divided into a new "Automatic Procedure" and a new "Ordinary Procedure", each with its own set of requirements and characteristics.

In addition, the offering documents subject to the Ordinary Procedure will all have the same standardised format, reflecting the type of product being offered – for example, equity funds will have their own standard offering document. Therefore, the regulation provides for a reduction in the amount of information usually required in the event of a public offering.

The new regulation also provides for a safe harbor that outlines situations in which such securities will not be required to have their offerings registered or approved. By way of example, there are provisions for:

- private placements in situations where the securities will receive investments from a sole investor (exclusive funds); and
- for closed-end funds that will not be subject to approvals in the event of subsequent offerings to its own quotaholders, if the fund/security holder has less than 100 investors.

BRITISH VIRGIN ISLANDS

Law and Practice

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

The British Virgin Islands (BVI) has long been a favoured jurisdiction for asset holding and transaction structuring among private equity sponsors, with clients benefitting from the jurisdiction's tax neutrality, robust legal system and ease of use and entity set-up. As long as these attractions remain, we expect the jurisdiction's popularity to continue and for BVI entities to retain a significant presence in M&A activity around the world.

1.2 Market Activity and Impact of Macro-Economic Factors

While other jurisdictions, including the Cayman Islands, have been dominant in the world of offshore investment funds, the BVI continues to increase in popularity in the closed-end sector of the industry. Increasingly, single-investor funds, single-investment funds and "club deals" are being structured through the BVI, in addition to co-investment vehicles set up to hold a single investment for one or more investors within the framework of an existing closed-end fund structure.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

The rise in BVI investment fund activity has been driven in part by certain differences in the regulation of closed-end funds between the Cayman Islands and the BVI, which are discussed below.

Limited Partnership Act (As Revised) (the "LP Act")

In addition to such regulatory arbitrage, the introduction in the BVI in 2017 of refreshed partnership legislation in the form of the LP Act has also attracted new users to the jurisdiction. The LP Act replaced the somewhat under-utilised international limited partnership regime and offers managers an extremely flexible and modern tool for structuring closed-end investment funds.

The LP Act draws significantly from the limited partnership regimes of other jurisdictions. BVI limited partnerships now share many of the features of those of other offerings, including broad freedom of contract and the ability to limit the liability of passive investors.

BVI limited partnership general partners are also subject to substantially the same unlimited liability for limited partnership debts and liabilities, as well as statutory duties to always act in good faith and (subject to any express provisions to the contrary in the limited partnership agreement) in the interests of the limited partnership.

The BVI limited partnership regime demonstrates a handful of technical refinements over and above those of certain other popular jurisdictions in the investment fund industry. For example, while it is not uncommon for limited partnership legislation to permit the use of non-domestic entities as general partners, under the LP Act a non-BVI entity does not need to first register as a foreign company in the BVI to be eligible to act as general partner of a BVI limited partnership.

BVI limited partnerships may also be formed with a separate legal personality – an option that is not available in all other competitor jurisdictions. While this does not make them separate

bodies corporate, it does permit any charge created over an asset of a BVI limited partnership that is then registered with the Registrar of Limited Partnerships in the BVI (the "Registrar") to have priority over any other charge over the same asset that is either unregistered or registered subsequently.

The registration process for BVI limited partnerships is straightforward and requires only submission to the Registrar of a registration statement (signed by each general partner) containing certain prescribed limited partnership information, a letter of consent from the limited partnership's proposed registered agent in the BVI, and confirmation of whether the limited partnership is to be formed with separate legal personality, together with the payment of the requisite USD750 government registration fee. Registration will usually take up to four working days.

Investment Business (Approved Managers) Regulations (As Revised) (the Approved Managers Regime)

Prior to the introduction of the Approved Managers Regime, all BVI managers of open- and closed-end funds were required to be fully licensed under the Securities and Investment Business Act (As Revised) (SIBA), which requires full compliance with the regulatory requirements of SIBA, the BVI's Regulatory Code (As Revised) and the BVI's anti-money laundering regime.

The Approved Managers Regime was introduced to address the fact that the systemic risk posed by start-up and existing mid-sized managers of both open- and closed-end funds is generally acknowledged to be lower than for those managing larger sums of investor money; application of the same regulatory requirements for all managers would lead to a disproportionate level of regulatory compliance costs for smaller managers.

The Approved Managers Regime is available to any qualifying BVI manager who acts as:

- an investment manager or investment adviser to private or professional funds recognised under SIBA, feeder funds into such funds and affiliates of those funds, as well as funds from "recognised jurisdictions" that have equivalent characteristics to BVI private or professional funds, provided the assets under management in such open-end structures are USD400 million or less;
- an investment manager or investment adviser to closed-end funds incorporated, formed or organised under the laws of the BVI or any recognised jurisdiction and that have the characteristics of a private or professional fund, together with their feeders and affiliates, provided the assets under management (ie, aggregate capital commitments) in such closed-end structures are USD1 billion or less; and/or
- an investment manager or investment adviser to such other person as the BVI Financial Services Commission (FSC) may approve on a case-by-case basis on application – this can include managed accounts.

The "recognised jurisdictions" for these purposes are currently Argentina, Australia, the Bahamas, Belgium, Bermuda, Brazil, Canada, the Cayman Islands, Chile, China, Curacao, Denmark, Finland, France, Germany, Gibraltar, Greece, Guernsey, Hong Kong, Ireland, the Isle of Man, Italy, Japan, Jersey, Luxembourg, Malta, Mexico, the Netherlands, New Zealand, Norway, Panama, Portugal, Singapore, South Africa, Spain, Sweden, Switzerland, the United Kingdom and the United States.

The Approved Manager Regime also permits an investment manager or adviser to provide services to a fund that is not from a recognised jurisdiction where such funds invest all or a substantial part of their assets in a qualifying fund based in the BVI or a recognised jurisdiction.

The Approved Manager Regime is becoming an increasingly popular choice for smaller managers seeking a regime and regulation more aligned with their business model.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

SIBA

BVI closed-ended funds are subject to regulation under SIBA if they constitute "private investment funds". A private investment fund is defined under SIBA as a company, partnership, unit trust or any other body that:

- collects and pools investor funds for the purpose of collective investment and diversification of portfolio risk; and
- issues fund interests that entitle the holder to receive an amount computed by reference to the value of a proportionate interest in the whole or in a part of the net assets of the company, partnership, unit trust or other body.

Accordingly, where there is no collective investment or diversification of portfolio risk, a fund will not technically constitute a private investment fund and accordingly will not be subject to regulation under SIBA. This is a notable driver of the increased use of the BVI for single-investor funds, single-investment funds, club deals and co-investment vehicles, as mentioned above – particularly where time is of the essence in deal structuring and execution.

SIBA imposes a general prohibition (with limited carve-outs) on the promotion of private investment funds and their carrying on of business unless and until recognised formally as such by the BVI FSC.

To be eligible for recognition, the constitutional documents of a private investment fund must:

- specify that the offer of fund interests to investors must be made on a "private basis" only;
- restrict the number of shareholders or investors to 50; or
- restrict the offer to "professional investors" and a minimum initial investment of USD100,000 for each such investor.

The application process for recognition requires the payment of application fees and the submission to the FSC of a completed application form together with a number of supporting documents, including the fund's constitutional documents, offering documentation (if any; if none, then an explanation for the lack of it must be provided) and valuation policy. The recognition process will typically take between five and seven working days following the submission of all required documents.

Private investment funds are subject to various ongoing obligations following recognition, including the retention of:

- a suitably qualified person – known as an "appointed person" – to take responsibility for undertaking the management, valuation and safekeeping of fund property;

- an auditor (although this need not be a local auditor based in the BVI), together with the submission to the FSC of annual audited accounts unless exempted under certain limited circumstances; and
- an authorised representative based in the BVI empowered to liaise with the FSC on a fund's behalf.

Any change to any of the foregoing personnel must be notified to the FSC within certain prescribed timeframes specified under SIBA.

Anti-money Laundering

The business of being a private investment fund constitutes "relevant business" for the purposes of the BVI Anti-Money Laundering (AML) Regulations (As Revised), and as a result, private investment funds are subject to the BVI AML regime. In addition to the regime's know-your-client (KYC) investor onboarding requirements, a private investment fund must also appoint a suitably qualified money laundering reporting officer.

The officer, who may be internal or appointed externally, will act as the liaison with the BVI Financial Investigation Agency in relation to AML compliance matters, and will have responsibility for ensuring compliance by the fund's staff with AML law and regulation, and any internal reporting protocols and compliance procedures the fund may have adopted.

A BVI investment fund that does not constitute a private investment fund under SIBA and is not otherwise regulated in the BVI will not technically be subject to the jurisdiction's AML regime. However, it is both recommended and accepted market practice for unregulated funds of this nature to conduct investor onboarding KYC and due diligence as if subject to the regime.

US Foreign Account Tax Compliance Act (FATCA) and the OECD's Common Reporting Standard (CRS)

BVI funds, whether recognised as private investment funds or not, will also constitute "(foreign) financial institutions" under FATCA and CRS (as each is extended to the BVI). Accordingly, such investment funds are subject to the regimes' registrations, account due diligence and account reporting requirements.

4. Due Diligence

4.1 General Information

It is uncommon for substantive activity to be undertaken by BVI entities within the territory itself, so BVI due diligence will typically be limited to an entity's constitution, books and records, and its compliance with applicable local law and regulation.

4.2 Vendor Due Diligence

It is not uncommon for a buyer to rely on vendor due diligence provided the transaction does not have any specific BVI regulatory or complex financial aspects. In such cases, the buyer may prefer their own due diligence report to address these issues.

5. Structure of Transactions

5.1 Structure of the Acquisition

The structure for the acquisition of shares in a BVI company will predominantly be driven by the structure of the shareholding. Where shares are closely held, the execution of a private treaty sale and purchase agreement or the use of applicable drag-along provisions would be typical. If shares are more widely held, it would be common to see the use of the BVI statutory

merger provisions. BVI statutory mergers have been a popular mechanism in the jurisdiction for many years, being used in both private and public transactions. Court-sanctioned schemes of arrangement are possible in the BVI but are not generally used. The terms of an acquisition will be driven by commercial rather than BVI-specific factors.

5.2 Structure of the Buyer

The single-investor, single-investment, club deal and co-investment fund structures that have become increasingly common in the BVI will quite often invest into underlying portfolio investments directly and will themselves be party to transaction documentation. BVI closed-end investment funds structured more as fully functioning blind pool funds – which remain rarer – will, however, more typically establish separate acquisition structures for their downstream transactions rather than investing directly. Such special purpose vehicles will usually be corporate entities and may be formed in a wide range of jurisdictions, including the BVI, with the choice often being driven by broader tax considerations.

5.3 Funding Structure of Private Equity Transactions

There is no overarching norm for the financing of transactions undertaken by BVI funds – nor need there be as a matter of BVI law, given the inherent flexibility that BVI investment structures can offer. The choice of financing methodology will therefore usually be driven more by commercial (and cultural) considerations at the sponsor, fund and portfolio company level.

5.4 Multiple Investors

Club deal arrangements and co-investment vehicles are more and more frequently being structured via the BVI, where they can avoid the need for private investment fund registration because they are established either for a single investment or a single investor.

Club deals will typically comprise a consortium of investors who will come together through a BVI aggregator vehicle to invest collectively and who will have management and economic rights apportioned between them, as agreed contractually.

Classic co-investment structures (where they involve multiple investors), however, will usually have investors take passive stakes as limited partners, with the vehicles then investing alongside the main private equity funds in which the co-investment vehicle limited partners are also separately invested.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

There is generally no restriction on the type of consideration that can be offered on a private treaty sale or negotiated offer. Consideration can therefore include, among other things, cash, loan notes and shares. The structuring of the consideration will be driven and agreed by the parties.

6.2 Locked-Box Consideration Structures

There is no common practice in the BVI; this will be driven and agreed by the parties in each transaction.

6.3 Dispute Resolution for Consideration Structures

There is no common practice in the BVI; this will be driven and agreed by the parties in each transaction.

6.4 Conditionality in Acquisition Documentation

There is no common practice in the BVI; this will be driven and agreed by the parties in each transaction.

6.5 "Hell or High Water" Undertakings

There is no common practice in the BVI; this will be driven and agreed by the parties in each transaction.

6.6 Break Fees

There is no common practice in the BVI; this will be driven and agreed by the parties in each transaction.

6.7 Termination Rights in Acquisition Documentation

There is no common practice in the BVI; this will be driven and agreed by the parties in each transaction.

6.8 Allocation of Risk

There is no common practice in the BVI; this will be driven and agreed by the parties in each transaction.

6.9 Warranty and Indemnity Protection

Warranty coverage in transactions in the BVI is generally limited to the title of target shares or assets, the capacity and authorisation to enter into the transaction, solvency and accuracy, and the completeness of the information provided to the buyer.

6.10 Other Protections in Acquisition Documentation

There is no common practice in the BVI; this will be driven and agreed by the parties in each transaction.

6.11 Commonly Litigated Provisions

Litigation of private equity transactions is rare in the BVI. The most likely reason for litigation would be the exercise of a dissenter's rights in the context of a statutory merger.

7. Takeovers

7.1 Public-to-Private

The market for take-private transactions involving BVI companies continues to be active, and these often involve private equity parties. There have been a number of take-privates in Asia involving Chinese ListCos, and in the UK involving companies listed on the London Stock Exchange.

There is no common practice in the BVI in respect of "relationship agreements", "transaction agreements" or other similar arrangements; any agreements between the parties will be determined by the parties in each transaction.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

There are no material shareholding or disclosure thresholds relevant under BVI law. Where the founders (and others) are leading a listed take-private transaction, disclosure around shareholdings in a target would usually be included in the offer documents for the transaction.

7.3 Mandatory Offer Thresholds

There are no material offer thresholds relevant under BVI law.

7.4 Consideration

Both cash and shares are commonly used in the BVI; there are no minimum price rules applying to tender offers in the BVI.

7.5 Conditions in Takeovers

Any conditions to an offer will be determined by the jurisdiction in which the business operates and relevant market considerations rather than by any BVI-specific factors. There are no restrictions, as a matter of BVI law, as to what deal-security measures a bidder can seek; break fees, match rights, force-the-vote provisions and non-solicitation provisions would all be permitted. However, it should be noted that, in agreeing any such provisions, the directors of a BVI company must act in accordance with their fiduciary duties (ie, their duties to act honestly, in good faith and in the best interests of the company).

7.6 Acquiring Less Than 100%

There are no restrictions under BVI law in respect of governance rights for a shareholder holding less than 100% of the issued shares of a company. In the absence of any provisions that state otherwise or class rights in the constitutional documents, a shareholder acquiring a majority of shares in a BVI company can amend the memorandum and articles of association, approve a statutory merger (subject also to board approval) and put the company into voluntary solvent liquidation.

There are two statutory mechanisms to squeeze out minority shareholders under BVI law. Members of a company holding 90% of the votes of the outstanding shares entitled to vote may give written instructions to the company directing it to redeem the shares held by the remaining shareholders. A squeeze-out will give rise to the right of the minority shareholder to dissent and receive payment for the "fair value" of their shares.

In addition, an alternate option is to squeeze out the minority by way of a statutory merger, as BVI law provides that a parent company (meaning a company that owns at least 90% of the outstanding shares of each class of shares in another company) may merge with its subsidiary without the need for shareholder approval. While it is unclear if, in the context of a parent-subsidiary merger, dissent rights are available to a minority shareholder, it would be prudent to make such right available to avoid any implication that the statutory merger route was used (as opposed to the statutory squeeze-out) to deny the minority shareholders the opportunity to dissent.

There are no specific thresholds or mechanisms under BVI law in connection with a "debt push-down"; any consents required would be subject to the usual corporate approvals depending on how the arrangement was structured.

7.7 Irrevocable Commitments

Where an offer is recommended by the board of directors of the target, obtaining irrevocable undertakings or commitments from the main shareholder(s) is common. There is no common practice in the BVI as to the timing or nature of the undertakings, which will be determined and agreed by the parties in each transaction.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

There is no common practice in the BVI; any terms will be determined and agreed by the parties in each transaction.

8.2 Management Participation

See **8.1 Equity Incentivisation and Ownership**.

8.3 Vesting/Leaver Provisions

See **8.1 Equity Incentivisation and Ownership**.

8.4 Restrictions on Manager Shareholders

See **8.1 Equity Incentivisation and Ownership**.

8.5 Minority Protection for Manager Shareholders

See **8.1 Equity Incentivisation and Ownership**.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

The extent and scope of control and governance rights enjoyed by BVI closed-end funds at the portfolio company level will often be driven by the relative size of the stake acquired, as well as by the market norms where the portfolio company is situated. This will therefore not usually be a question driven by BVI-specific matters.

9.2 Shareholder Liability

The "corporate veil" effectively separates the legal person who owns a company from the company itself. A duly incorporated BVI company is a legal entity separate from those who incorporate it, with rights, liabilities and property of its own. This is also the position within a group of companies where the fundamental principle is that each company in a group is a separate legal entity possessed of separate legal rights and liabilities.

Under BVI common law, the circumstances where a BVI court will allow the corporate veil to be "pierced" or "lifted", so as to hold a member of a company liable for the company's acts, are rare and limited. Such circumstances include, for instance, where a company is misused as a device or façade to conceal wrongdoing, or is used for an illegal or immoral purpose.

10. Exits

10.1 Types of Exit

There is no typical practice in the BVI, with private equity funds being established with a wide variety of exit terms. "Dual-track" and "triple-track" exits are uncommon.

10.2 Drag and Tag Rights

It is common to see the inclusion of drag rights in the constitutional documents of BVI companies. There are no typical terms in the BVI; these will be determined and agreed by the commercial parties in each transaction rather than by any BVI-specific factors.

As with drag rights, the use of tag rights is common in the BVI. Again, there are no typical terms in the BVI; these will be determined and agreed by the parties in each transaction rather than by any BVI-specific factors, legal or otherwise.

10.3 IPO

The use of BVI entities to effect IPOs on a variety of international exchanges is a well-trodden path. However, the terms of any lock-up arrangements or ongoing relationships will be determined by reference to the relevant exchange and jurisdiction rather than by any BVI-specific factors.

CANADA

Law and Practice

Contributed by:
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Fasken is one of Canada's largest business law firms, providing strategic advice on private equity transactions. The private equity group comprises more than 200 lawyers, who offer knowledge through every stage of the investment cycle, from fund formation, LBOs and take-private transactions, co-investments, portfolio add-ons, tuck-ins and other M&A through to liquidity exits via strategic sale, auction processes or IPO. The group regularly acts for Canadian and international private equity funds, pension funds and other institutional investors, as well as a broad range of portfolio companies and founder-owned and operated businesses in a variety of industries. Fasken has renowned industry experience across the industrial, technology, retail, financial services, infrastructure and projects, mining, and energy and climate sectors, amongst others. As a full-service firm, Fasken also offers leading practice groups covering fund formation, M&A, banking, capital markets, governance, ESG, tax, competition, marketing and foreign investment, regulatory, privacy and cybersecurity, labour and employment, litigation, and insolvency and restructuring, making the firm a true "one-stop shop" for clients' legal needs.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

Rebound: 2024's Modest Revival after a 2023 Slump

With the end of 2023 seeing low transaction volume in private equity transactions due to the high interest rate environment, the first half of 2024 is showing signs of recovery in the Canadian market with a significant rise in deal volume.

We have notably witnessed a significant surge in add-on investment activity and sale processes. Private equity exit value in the beginning of 2024 has additionally exceeded the total exit value for all of 2023.

While M&A markets continue to be burdened by the high interest rate environment, expectations are starting to set for a stabilised inflation market. The current market nonetheless presents challenges as high interest rates, rocky capital markets, financing strains and investor pressures continue to cause valuation stress.

1.2 Market Activity and Impact of Macro-Economic Factors

2023 notably saw a jump in deals in the agribusiness space. Small and medium-sized businesses continue to dominate deal-making for private equity activity with a notable lack of mega deals in the market given the financing constraints in the higher interest rate environment.

Cleantech deals throughout 2023 matched 2022 record highs in the Canadian market. Investors are energised to enter this industry segment given the heightened interest in ESG-related companies.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

On 22 June 2023, Canada enacted new rules requiring taxpayers to provide written notice to the Canada Revenue Agency of certain transactions. Two general categories of transactions are subject to these new rules: reportable transactions and notifiable transactions. Despite lingering ambiguities surrounding the application of these categories, parties who undertake commercial transactions in Canada should be aware of the possible application of the new rules. In particular, any transaction that involves one or more specific steps to address tax planning should be carefully reviewed to assess the applicability of the new rules.

In 2023, Canada enacted new rules requiring taxpayers to provide written notice to the Canada Revenue Agency of certain transactions. Two general categories of transactions are subject to these new rules.

The first is "reportable" transactions. A reportable transaction is generally any transaction where (i) one of the main purposes of the transaction is to obtain a tax benefit and (ii) one of three "hallmarks" is present in the transaction. These hallmarks are complex but a hallmark will generally be present if:

- an adviser or promotor is entitled to a fee based on the tax benefit realised or the number of people who benefit from the tax benefit (this is generally referred to as the "Contingency Fee" hallmark);
- an adviser or promoter who was involved in the implementation of the transaction has obtained confidentiality protection that prohibits the disclosure of the transaction (this

is generally referred to as the "Confidential Protection" hallmark); or
- a party who is involved in the transaction is entitled to insurance or protection against the failure of the transaction to obtain a tax benefit (this is generally referred to as the "Contractual Protection" hallmark).

If the main purposes of a transaction, including one transaction within a series of related transaction, is to obtain a tax benefit and any one of the hallmarks is present, the taxpayers involved in the transaction as well as their advisers must each file a report with the CRA within prescribed time limits (generally 90 days after the transaction was entered into). A failure to do so triggers a number of potential sanctions including monetary penalties, an extension of the tax assessment period and a deemed waiver of certain defences to tax assessments based on the General Anti-Avoidance Rule (GAAR) set out in the Income Tax Act (Canada).

The second category of transactions that are subject to the rules are "notifiable" transactions. These transactions are specific transactions that have been identified by the CRA as requiring notification. On 1 November 2023, the Canada Revenue Agency designated five transactions and series of transactions as "notifiable transactions".

The consequences of failing to report a notifiable transaction are largely the same as the penalties for failing to report a reportable transaction.

While the application of the reportable and notifiable transaction still contains several uncertainties, parties who undertake commercial transactions in Canada should be aware of the possible application of the rules. In particular, any transaction that involves one or more specific steps to address tax planning should be carefully reviewed to assess the applicability of the rules.

In an effort to combat forced and child labour, the Canadian Parliament passed bill S-211 An Act to enact the Fighting Against Forced Labour and Child Labour in Supply Chains Act, which imposes an annual reporting requirement on Canadian businesses, including those operating outside of Canada. The initial reporting requirement was due in May 2024, though the government's web portal remains open for voluntary late filings.

The act applies to businesses that are either (i) listed on a Canadian stock exchange; or (ii) have a place of business in Canada, do business or have assets in Canada and meet at least two of the following size requirements based on consolidated financial statements:

- have at least CAD20 million in assets;
- generated at least CAD40 million in revenue; or
- employ an average of at least 250 employees.

In all cases, so long as the businesses produce, sell or distribute goods in Canada or elsewhere or import goods into Canada, the business will be required to submit an annual report that sets out the steps taken during the previous financial year to prevent and reduce the risk of forced or child labour being used in any steps of production. The annual report must be made publicly available, including through publication on the website of the business and, for federally incorporated corporations, distributed to shareholders. Private equity funds will need to consider these new developments in their targets and existing portfolio companies as they require an added level of scrutiny at the diligence level and an increase in the reporting burden.

Russia's invasion of Ukraine has been met with a flurry of sanctions from Canada, the US, the EU, the UK, Japan and other countries. All these sanctions are similar in structure, in that they will:

- impose asset freezes and dealing prohibitions upon listed persons;
- prohibit activities in certain sectors, such as banking and energy; or
- impose transaction prohibitions involving certain countries or regions (Crimea).

Violations of sanctions laws typically include both civil and criminal penalties, raising the risk of severe business and reputational consequences, multimillion-dollar fines and incarceration. The civil penalties are typically strict liability, meaning that simply violating the law, regardless of intent, may give rise to liability. Criminal sanctions arise when companies wilfully fail to make reasonable inquiries or conduct due diligence into potential sanctioned activity involving, for example, sanctioned buyers, investors or banks. The complexity and expanding scope of sanctions make compliance particularly difficult for companies.

In light of these potentially severe outcomes on company profitability, private equity investors are looking at whether target companies are following best practices in terms of:

- conducting risk assessments of the various sanctions regimes that may apply to their businesses and the risks posed by their customers, the products or services offered, their supply chains and their geographic footprints;
- implementing internal controls to ensure that all entities involved in a transaction are identified and screened, including the beneficial owners of corporations or entities providing financing;
- applying quality written policies that can guide the day-to-day activities of employees and identify clear lines of responsibility for screening and reporting any potential violations;
- training employees; and
- testing and auditing.

The trend over the past five years indicates that sanctions laws will continue to proliferate, increase in scope, coverage and complexity, and assume an increasingly important role in corporate transactions and compliance. The role of sanctions best practices by companies has been "mainstreamed" and is now an indicator of whether a company is practising good corporate governance.

Very generally, CCPCs are Canadian private corporations that are not controlled by one or more public corporations or non-resident persons, and are subject to certain benefits under the Income Tax Act (Canada) (ITA). Such benefits include a lower rate of tax on qualifying active business income, enhanced investment tax credits and the potential for shareholders to benefit from the lifetime capital gains exemption on capital gains realised on the sale of their shares.

However, CCPCs are subject to additional taxes on their investment income, which includes income from property and capital gains. Such additional taxes are generally wholly or partially refundable following the payment of taxable dividends by the CCPC. The policy behind the refundable taxes is to eliminate any tax-deferral opportunity on investment income earned in a corporation compared to circumstances where individual shareholders earn the investment income directly.

For CCPCs, the combined federal and provincial corporate tax rate on investment income is therefore approximately equal to 50% (and 25% for capital gains). In comparison, non-CCPCs (such as public corporations or corporations controlled by non-residents of Canada) are not subject to the aforementioned refundable tax on similar investment income, thus resulting in a tax rate of approximately 25% (and 12.5% for capital gains), depending on the province of residency. Planning in private equity sale transactions was developed to take advantage of this discrepancy, and was achieved by signing a purchase and sale agreement pursuant to which a non-resident or public corporation (the "Purchaser") would acquire a right to acquire control of a CCPC (the "Target") from Canadian sellers (the "Sellers"), thereby resulting in the loss of CCPC status and a deemed tax year-end for the Target immediately before the signing of the agreement. Prior to the closing of the sale, latent capital gains attributable to depreciable assets would be realised by the Target, thereby resulting in corporate taxes (computed based on the lower non-CCPC rate), and in an equivalent reduction of the purchase price of the Target's shares for the Purchaser. Such gains would also generate tax attributes which, in some circumstances, could be used by the Sellers to increase the cost of their shares in the Target and thereby reduce the capital gains they might otherwise have realised on the sale of the Target shares. The result was that a significant portion of the gain realised by the Sellers would be taxed at 12.5%, rather than 25%. In addition, the transactions undertaken had the effect of increasing the future amortisable basis of the depreciable assets of the Target, to the benefit of the Purchaser.

In order to eliminate this type of planning, the 2022 federal budget ("Budget 2022") introduced the notion of "substantive CCPCs", which are private corporations resident in Canada that are not CCPCs but that are controlled in law or in fact, directly or indirectly, by one or more Canadian-resident individuals. Importantly, a substantive CCPC includes a corporation that would otherwise be a CCPC but for a non-resident or a public corporation having a right to acquire its shares or because it ceased to be a Canadian corporation. Substantive CCPCs are to be subject to the same higher income tax rates and the refundable tax mechanism that is applicable to CCPCs, and the investment income earned by a substantive CCPC is added to its "low rate income pool", which when paid out as a dividend to individual shareholders is not eligible for the enhanced dividend tax credit. Moreover, substantive CCPCs do not benefit from the other tax advantages usually conferred to CCPCs, such as those described above.

Generally, these amendments apply to taxation years ending after 7 April 2022 ("Budget Day"). However, there is an exception for taxation years ending due to an acquisition of control caused by the sale of all or substantially all of the shares of a corporation to an arm's length purchaser where the purchase and sale agreement is entered into before Budget Day and the share sale closes before the end of 2022.

A recent amendment to the Alberta Business Corporations Act (ABCA) may have an impact on the incorporation of private equity-backed corporations in Canada. Under the ABCA, an Alberta corporation may now include a corporate opportunity waiver in its shareholder agreement, whereby the corporation expressly waives any interest (present or future) in a particular business opportunity so that a director, officer or shareholder may participate or pursue such opportunity. This waiver is generally seen as

being beneficial to private equity funds that have board representation on multiple corporations competing in the same industry, as it increases certainty for those directors that their actions will not violate fiduciary duties they would otherwise owe to each corporation at common law. As Alberta is currently the only jurisdiction in Canada with a corporate opportunity waiver provision in its corporate statute, it is anticipated that an increasing number of private equity-backed corporations will be incorporated in that province.

As of 13 June 2019, companies governed by the federal statute in Canada – the Canada Business Corporations Act (CBCA) – are required to maintain a detailed shareholder register that reflects all individual shareholders who have significant direct or indirect control over the corporation. This obligation extends beyond the previous corporate obligation, which was to maintain a list of registered holders only. The purpose of this reform, like its counterparts in the EU and the UK, is to provide greater transparency in corporate ownership and help combat tax evasion, money laundering and other smoke screen operations. Practically speaking, private equity funds often hold controlling positions (in terms of percentage owned or in fact through shareholder arrangements) in their portfolio companies governed by the CBCA and should therefore be prepared to provide additional information about their own controlling interests. Provincial and territorial finance ministers have agreed to follow the federal lead in this area, although the timing of their doing so is uncertain.

Effective 31 March 2023, Bill 78, An act mainly to improve the transparency of enterprises, requires any companies that are registered with the Enterprise Registrar of Québec to disclose the ultimate beneficiaries of the entity, being a person who:

- is a holder or beneficiary, directly or indirectly, of a number of shares or units of the company conferring on that person the power to exercise 25% or more of (i) the voting rights attached to the shares or units; or (ii) the fair market value of all the shares or units of the company; or
- has a direct or indirect influence that, if exercised, could result in de facto control of the company.

Additionally, entities must provide, for individuals or entities that are registered in the Enterprise Registrar (directors, officers, three largest shareholders and ultimate beneficiaries), the dates of birth and professional address or domicile of each individual or entity, as applicable, as well as government identification for each director.

Businesses operating in Québec must respect the Charter of the French Language (colloquially known as “Bill 101”), which requires companies to meet French language requirements in various settings (including with employees, in contractual undertakings, and on websites and advertising). Foreign investors are sometimes mystified by this law. However, with Québec accounting for 55% of total private equity deal flow in Canada for 2023, acquiring an existing Québec operation has a distinct advantage over growing the business organically in the province in this respect, as the local operation should already be familiar with the Charter requirements and have measures in place to ensure compliance.

While currently just good policy and not statutorily required practice in Canada for private companies, there has been heightened attention on diversity for board and management composition and on ESG criteria, including boards having the ability to take into consideration the interest of a company’s stakeholders rather than

solely its shareholders. These factors have been edging their way through limited partner investment criteria and into requirements imposed on portfolio companies themselves as they carry out their business plans in 2024 and beyond. If private equity investors exit their investments by way of an IPO, they will need to take into account disclosure obligations for public companies related to diversity matters, and proposed disclosure obligations for public companies related to climate change matters.

The protection of personal information in Canada is governed by the Personal Information Protection and Electronic Documents Act (PIPEDA) and by substantially similar legislation in certain provincial jurisdictions. Canadian organisations may be subject to multiple Canadian privacy laws, as applicable legal privacy requirements depend on factors such as the geographic location of the individuals concerned and of the business related to the information being handled, as well as the place where the information is collected, hosted and processed.

In the past three years, the provincial and federal governments have noted their intention to reform the Canadian privacy legal and regulatory landscape. While several Canadian jurisdictions are still at the early stage of privacy reforms, changes to Quebec's Act respecting the protection of personal information in the private sector introduced under Bill 25 are in force, with further amendments being introduced in September of 2024 regarding the right to data portability.

In tandem with the act strengthening potential fines (which include penal sanctions of up to CAD25,000,000 or 4% of global turnover, whichever is greater), the act has also introduced a strengthened consent regime, mandatory prior risk assessments for IT projects and cross-border data transfers, and transparency obligations related to the use of automated decision-making systems. In recent months, a specific regulation has been enacted to address the new mandatory security incident reporting requirements and another one has been adopted to address the particularly high threshold for data anonymisation.

In parallel, the Canadian government's second attempt to reform federal private sector privacy legislation in Bill C-27 remains subject to the ongoing legislative process and is currently at the stage of consideration in committee in the House of Commons. This bill also aims to introduce a regulatory framework for the development and use of Artificial Intelligence systems, based on a sectoral and risk analysis approach (Artificial Intelligence and Data Act).

Arguably one of the largest drivers of M&A and restructuring activity in Canada in H1 of 2024 was due to the capital gains reform. Prior to 25 June 2024, one-half of any capital gain realised constituted a taxable capital gain included in a taxpayer's income. With this year's federal budget, the government of Canada increased the percentage to two-thirds for all capital gains realised by corporations and trusts, and for capital gains realised by individuals in excess of CAD250,000 annually. Many businesses sought to complete transactions to crystalise their capital gains prior to this date.

On 16 April 2024, the Minister of Finance presented the Government of Canada's 2024 Federal Budget, which led to proposed amendments contained in a Notice of Ways Motion dated 10 June 2024 (the "Proposals"). Such Proposals would, if enacted as proposed, increase the proportion of a capital gain included in income as a taxable capital gain, or the proportion of a

capital loss that constitutes an allowable capital loss, from one-half to two-thirds, effective for dispositions on or after 25 June 2024. The Proposals generally provide that the one-half inclusion of capital gains will continue to apply to individuals (other than trusts) up to a maximum of CAD250,000 of net taxable capital gains per year. For tax years that begin before and end on or after 25 June 2024, two different inclusion rates will apply, and transitional rules apply to separately identify capital gains and losses realised before and after that date. The Proposals also contemplate adjustments of carried forward or carried back allowable capital losses to account for changes in the relevant inclusion rates. In addition, the Proposals contain complex transitional rules applicable to trusts that realise net taxable capital gains during the relevant period in order to determine, generally, the portion of those gains that will be treated as being subject to the one-half and two-thirds inclusion rates, including where an amount in respect of that gain is paid or payable to a beneficiary.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

M&A activity in Canada is governed by federal and provincial corporate statutes, provincial/territorial securities laws and, where applicable, stock exchange rules. The Competition Bureau (Bureau) is responsible for antitrust considerations in Canada through the application of the Competition Act, and foreign investment is monitored by the Minister of Innovation, Science, and Economic Development through the application of the Investment Canada Act (ICA); both are key considerations in private equity-backed transactions.

Residency Requirements and Language Laws

The federal statute and certain provincial laws (Alberta, Saskatchewan, Manitoba, Newfoundland and Labrador) impose minimum Canadian residency requirements for board composition (25% resident Canadian, or at least one board member if the board is composed of fewer than four members), which sometimes influence the jurisdiction in which purchaser companies are formed by foreign private equity investors. The remaining provinces and territories, notably British Columbia, Ontario and Québec, do not have such limitations.

Securities Regulators

Canada has no federal securities law or regulator. Securities laws are covered by ten provincial and three territorial regulators, although the applicable authorities are generally substantially equivalent in regulating securities matters across the country.

Competition Act

The Competition Act prescribes a “transaction-size” threshold, a “party-size” and, in the case of transactions involving the acquisition of voting shares, a “shareholding” threshold for acquisitions of operating businesses with assets in Canada. If each of these thresholds is exceeded, a transaction is considered “notifiable” and, subject to certain limited exceptions, triggers a pre-merger notification filing. Transactions exceeding such thresholds cannot close until notice has been provided and the statutory waiting period has expired or has otherwise been terminated or waived.

The “transaction-size” threshold is subject to annual adjustment. In 2024, the transaction-size threshold requires the value of assets in Canada of the target (or, in the case of an asset purchase, the value of assets in Canada being

acquired) or the gross revenues from sales in or from Canada generated by those assets to exceed CAD93 million.

The "party-size" threshold requires the parties to a transaction, together with their affiliates, to have aggregate assets in Canada or annual gross revenues from sales in, from or into Canada that exceed CAD400 million.

The "shareholding threshold" requires the acquiror to hold at least a prescribed percentage of the target's voting shares. In the case of private companies, the threshold is more than 35% (or more than 50% if the 35% threshold is already exceeded). In the case of public companies, the threshold is more than 20% (or more than 50% if the 20% threshold is already exceeded).

For the purposes of both the "transaction-size" and "party-size" thresholds, asset values are calculated having regard to the book value of the assets in Canada rather than the fair market value of the assets in Canada.

Foreign Investments

Pursuant to the ICA, the acquisition of control by a non-Canadian of a Canadian business is either reviewable or notifiable depending on several factors, including the structure of the transaction, the nationality of the investor, and the nature and value of the assets or business being acquired.

In summary, the direct acquisition of control of a Canadian business by a non-Canadian is subject to pre-closing review where one of the following thresholds is exceeded:

- CAD1.326 billion in enterprise value for a direct acquisition of control of a Canadian non-cultural business by a WTO investor that is not a foreign state-owned enterprise (SOE);
- CAD1.989 billion in enterprise value for a direct acquisition of control of a Canadian non-cultural business by a "trade agreement investor" (ie, an investor from a country with which Canada has a trade agreement, such as the US or the EU) that is not a foreign SOE;
- CAD528 million in asset value for a direct acquisition of control of a Canadian non-cultural business by a foreign SOE controlled by a WTO member state;
- CAD5 million in asset value for a direct acquisition of control of a Canadian non-cultural business by a non-WTO investor; and
- CAD5 million in asset value for a direct acquisition of control of a Canadian cultural business.

Indirect acquisitions of control of a Canadian non-cultural business by a WTO investor are not subject to pre-closing review, regardless of size. In contrast, indirect acquisitions of control of a Canadian non-cultural business by a non-WTO investor are subject to pre-closing review where the book value of the Canadian business' assets is at least CAD50 million.

A transaction that is subject to pre-closing review cannot be completed unless the Canadian government is satisfied that the investment is likely to be of "net benefit to Canada". The government's net benefit analysis takes into account a number of factors, including:

If the applicable threshold for a pre-closing review of the net benefit to Canada under the ICA is not met or exceeded, the acquisition of control of any Canadian business by a non-Canadian is subject to a relatively straightforward notification, which can be made either before or within 30 days of closing.

Separate and apart from the net benefit to Canada review process, the ICA also contains a mechanism to allow the Canadian government to review a foreign investment on national security grounds. There are no thresholds for such national security reviews; they can be initiated at the discretion of the government.

As Canada relies heavily on its trading partners and is generally supportive of foreign investments that do not raise national security concerns, historically "net benefit to Canada" approval under the ICA, where required, is seldom denied. However, on 4 July 2024, the Minister of Innovation, Science Industry, issued a statement indicating that when it comes to "net benefit" reviews of foreign investments in large Canadian-headquartered firms engaging in critical mineral operations (presumably falling within Canada's critical minerals list), "such transactions will only be found of benefit in the most exceptional of circumstances". It is important to note that this statement relates to net benefit reviews, and not national security reviews. More importantly, this policy applies to all foreign investors, regardless of jurisdiction of origin or whether the investor is a state-owned enterprise.

4. Due Diligence

4.1 General Information

Comprehensive due diligence is customary for a private equity transaction in Canada. Financial, tax, operational, environmental and general business diligence (including key partner, client and customer audits and meetings) is conducted with the private equity deal team for a new platform investment, and through a combination of the private equity deal team and existing management for add-on acquisitions. Consultants may be engaged to cover environmental risks, client audits or other industry-specific considerations.

General legal diligence will include a combination of:

- a review of publicly available documentation (websites, confidential information memorandum and public disclosure documents, if available);
- preparing a detailed list of standard questions to be answered in writing by the target and its counsel, including topics covering corporate history, shareholder arrangements, material reorganisations, acquisitions and divestitures, commercial agreements, debt arrangements, IP/IT, privacy and cyber-risk, environment, real estate, regulatory compliance, litigation, labour, employment and benefits, and tax;
- a review of a data room and other materials provided in response to the diligence questions; and
- follow-up calls with relevant members of management on specific areas of interest.

Key areas of focus will vary depending on the industry in which the target operates. Over the past several years, we have seen private equity buyers have a heightened focus on privacy, cyber and IT diligence conducted by both the operations and legal teams, as well as on sanctions and import/export considerations.

4.2 Vendor Due Diligence

Vendor diligence reports are not customary in Canada. Legal advisers rarely provide reliance on their buy-side diligence reports to other third parties other than their private equity clients and the portfolio companies in the case of add-on acquisitions, although pressure to conform to European trends has increased in recent months in this regard.

Vendors typically provide a Confidential Information Memorandum (CIM), a detailed financial model, and, depending on the stage and scope of the sale process, populated disclosure schedules based on representations and warranties provided in the vendor draft purchase agreement.

5. Structure of Transactions

5.1 Structure of the Acquisition

Unless there is a significant known liability that needs to be carved out through structuring as an asset sale, the vast majority of private equity transactions in Canada are completed via share purchase agreements.

Where the target has multiple shareholders or there has been significant restructuring of equity plans or other specific challenges in obtaining all required corporate approvals, and in the case of public company targets, a plan of arrangement may be used. An arrangement is a court-sanctioned agreement (similar to the UK scheme) that can accommodate various structures (share purchase, amalgamation) and complex capitalisations. Although a plan of arrangement can be more costly and take slightly longer than a simple share purchase, it is an efficient way to "clean up" messy capitalisation, providing certainty to the buyer through the court's seal of approval.

Very few private equity deals are conducted by way of a takeover bid (whether friendly or hostile) in Canada. Regulatory hurdles and complex, extensive requirements for non-Canadian bidders are major deterrents, as are the delays and costs associated with possible second-step ("squeeze-out") transactions.

The terms of the purchase agreement can vary significantly depending on the private equity player backing the purchaser and the strategic importance of the acquisition to an existing portfolio or the creation of a new platform, as applicable. In a competitive auction, the terms tend to be more balanced, and seller-friendly provisions (eg, shorter duration and smaller amount of indemnification holdback, acceptance of more pervasive qualifiers in the representations and warranties, shorter lists of closing conditions, and a more limited indemnification regime) and the use of representation and warranties insurance are more prevalent.

5.2 Structure of the Buyer

In Canada, a private equity-backed buyer will rarely be party to the purchase agreement directly. Where a newly created "shell" company is the purchaser, a fund may concede to providing equity commitment letters and causing banks to provide debt commitment letters as to the funding of the acquisition, and would also provide a limited guarantee to fund any reverse break-up fee, as the case may be, but this is more likely to be provided as a standalone undertaking as opposed to the fund intervening in the purchase agreement directly. In the case of public company targets, the board will require debt and/or commitment letters, as applicable, before signing off on definitive agreements (even where there is no formal "funds certain" statutory requirement to do so, as this obligation only applies to takeover bids in Canada).

With respect to exits, as most private transactions are structured as share purchase agreements in Canada, it is customary to have all shareholders (including the private equity players) execute the sale agreements, with indemnification obligations being individually (and not

jointly) allocated proportionately amongst the various sellers.

5.3 Funding Structure of Private Equity Transactions

The funding of private equity-backed M&A in Canada varies from transaction to transaction. Certainty of funding is only required under Canadian legislation for a takeover bid. As mentioned in **5.2 Structure of the Buyer**, equity commitment letters are often provided by the private equity fund, particularly in competitive auction processes, with more sophisticated sellers and, in the case of privatisations, to provide vendors with comfort that funding will be available for the transaction. On the debt financing side, the so-called "SunGard/Limited conditionality" provisions have made their way into debt commitment letters. While more often seen in the large-cap space, the provisions are also seen in middle-market transactions.

The financing of an acquisition itself varies from one fund to the next, in terms of debt/equity combinations (or cash on hand, in the case of add-on acquisitions within a platform). Financing for these deals usually involves a minimal equity commitment by the private equity fund, with the remainder of the funds being provided by traditional bank debt and other mezzanine lenders. Despite lenders remaining selective, credit in Canada continues to be available in the market, with a range in financing from 3.0-5.0+ times EBITDA for secured financing, depending on the type of industry and assets available for security. However, with high interest rates, financial covenant breaches continue to be more prevalent in leveraged buy-out financings recently implemented. As such, in several circumstances, lenders were asked to waive or tolerate financial ratio breaches, leading to flexing the terms and conditions of such financings. The flexed terms often include an increase in their pricing and the tightening of certain negative covenants such as incurrence of debt, permitted acquisitions and investments and sometimes introducing a capital expenditures cap.

As for the leveraged buy-out financings being implemented in 2024, the deal terms remained correct and lenders may require a higher percentage of equity in the acquisition capital structure (which in turn propels an uptick in rollovers and the use of contingent payment structures). So long as interest rates remain high, lenders have the upper hand in negotiating more restrictive financing terms. However, with inflation under control, the Bank of Canada has cut its key interest rate by 50bps as of June 2024. Other cuts are expected during the remainder of the year which will leverage negotiations in favour of sponsors and borrowers.

5.4 Multiple Investors

Deals involving a consortium of private equity sponsors are common in Canada, particularly in light of the role played in private equity by public sector pension plans and other quasi-governmental vehicles. "Club deals" with multiple private parties and no clear majority controlling fund involved are less frequent, perhaps due to the relative size of Canadian deals, which tend to be smaller and thus not require the same capital requirements as other markets.

It is not uncommon for a lead private equity investor to have provided for co-invest rights to its limited partners, or to partner with other private equity funds. In such cases, detailed shareholder rights are negotiated concurrently with the acquisition in a shareholders' agreement for the platform company(ies). Introducing additional investors following the initial investment is also considered, although such circumstances

require a careful review and often lengthy renegotiation of the shareholders' agreement already in place.

In some instances, the limited partners wishing to participate in a co-investment opportunity may be required to invest through a special purpose investment fund set out and controlled by the sponsors. This allows the sponsors to effect such co-investment opportunity more expeditiously and avoid lengthy discussions, as such co-investors' entitlements are limited to a participation in a limited partnership controlled by the sponsors.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Consideration structures in Canadian private equity transactions continue to be predominantly based on closing date financial statements (ie, an estimated purchase price is paid at closing), subject to a working capital adjustment (and other possible adjustments depending on the business) upon completion of financial statements as of the effective time that is typically secured with an escrow. In the case of privatisation transactions, fixed-price agreements dominate.

Parties continue to rely on earn-outs or other contingent consideration. In 2023, 32% of deals were reported to contain earn-outs. Certain of these earn-outs were quite substantial relative to the overall purchase price and the terms of these earn-outs are becoming more creative.

Notwithstanding the foregoing, the vast majority of private equity sellers are still relatively resistant to contingent consideration and will tend to limit any recourse post-closing to the purchase price consideration by using representations and warranties insurance or very time-limited indemnities and escrows. This approach differs from a typical strategic corporate seller, who may entertain an escrow and longer indemnities.

Private equity buyers continue to rely heavily on representations and warranties insurance to provide vendors with full consideration with minimal escrow and indemnification provisions. Although many deals continue to provide for indemnification escrows and robust indemnification clauses, the duration and scope have been diminishing in recent years. In fact, there is a growing trend, particularly in competitive situations, of purchase agreements with public company-style representations and warranties packages with zero recourse after closing, although this trend appears to have slowed down in 2023 given recent market conditions. In contrast, transactions with zero post-closing recourse are not as frequent for strategic corporate buyers.

6.2 Locked-Box Consideration Structures

Locked-box structures are uncommon for private equity funds in private M&A in Canada, which continue to favour a traditional working capital adjustment as of the date of closing. Given the limited sample size, it would be imprudent to comment on what is "typical" in a locked-box structure in this market.

6.3 Dispute Resolution for Consideration Structures

A detailed dispute resolution mechanism with respect to purchase price adjustments is a standard provision in Canadian private equity share purchase agreements, whether on the buy side or the sell side. Traditional features of this provision include the appointment of an independent third party who evaluates only the spe-

cific items identified in the disagreement, and the terms upon which the selling and the buying party are to interact and share information with this independent third party. Typically, this party's decision is binding, and fees and expenses for the independent third party would be allocated between the buyer and seller in the same proportion that the unsuccessfully disputed amount submitted bears to the total amount of disputed items submitted to such independent third party.

Dispute resolution on other deal terms is typically through recourse to the courts. Arbitration (binding or not binding) is rare in Canadian private equity deals.

6.4 Conditionality in Acquisition Documentation

Conditions precedent to the closing of a private equity transaction vary considerably from one deal to another. Regulatory approvals (including the Competition Act and the ICA, where applicable) and required board and shareholder approvals are nearly universally imposed. In the case of other third-party consents (eg, material customers, landlord, etc), the conditionality of such provisions (required, best efforts, reasonable commercial efforts, no obligation) varies depending on the comfort level the private equity buyer has obtained in its due diligence, its familiarity with the other parties and its general operating practices. Financing conditions are less common and are typically found when the private equity buyer has substantial bargaining power over the target. Finally, a standalone condition that there be no material adverse effect between signature and closing is relatively common for a private equity buyer to require.

Prevailing market conditions during the COVID-19 pandemic had the effect of reducing closing conditions to a minimum as buyers were in a situation to require closing certainty. However, the marketplace is trending back to a more balanced approach.

6.5 "Hell or High Water" Undertakings

A "hell or high water" undertaking is sometimes accepted in private equity deals in Canada where there is a regulatory condition related to, for example, the merger review process or the foreign investment review process. As a practical matter, a full "hell or high water" is more likely to be provided in the merger review context than in the foreign investment review context. That said, the scope of "hell or high water" undertakings is negotiated and ultimately depends on the nature and regulatory sensitivity of the deal and business dynamics. For example, in the context of a "seller's market" and regulatory complexity, such undertakings may involve the sharing of risk (rather than a full "hell or high water") and/or specific remedial commitments.

6.6 Break Fees

Prior to the COVID-19 pandemic, break fees were rarely accepted by private equity-backed buyers in private transactions. The height of the sellers' market in 2021 saw many private equity sponsors required to provide limited guarantees and equity commitment letters to support break fees being demanded by sellers. Where such provisions are accepted, it tends to be in a privatisation context and countered with a reverse break fee (or, at a minimum, a reimbursement of expenses clause).

Reverse break fees do arise if the transaction is conditional on financing, thereby limiting the private equity firm's exposure if financing does not take place. Many private equity sponsors were required to provide equity commitment letters and limited guarantees to secure a prospective acquisition.

In a friendly public take-private transaction, a reverse break fee is typically payable to the purchaser in connection with the exercise of a fiduciary out by the target board for a superior proposal.

6.7 Termination Rights in Acquisition Documentation

Purchase agreements structured as two-step (sign and then close) transactions typically provide for termination in the case of:

- mutual agreement;
- termination by the buyer (provided the buyer is not in default of its obligations) where the obligations of the seller cannot or have not been satisfied by an outside date; and
- termination by the seller (provided the seller is not in default of its obligations) where the obligations of the buyer cannot or have not been satisfied by an outside date.

The failure to obtain regulatory or government approvals, third-party consents or appropriate financing are the most frequent obligations triggering these termination rights. A typical long stop date (or "outside date", in Canadian terms) is set on a case-by-case basis, taking into account the anticipated level of complexity of obtaining regulatory approvals (if any) and any other closing deliverables (such as required consents, necessary pre-closing transactions, etc).

6.8 Allocation of Risk

Private equity buyers are not sympathetic to assuming risks related to a business before they become owners, instead adopting the principle of "your watch/our watch" for all matters. However, risk allocation can be more tempered in a competitive auction process and, depending on the nature or extent of diligence conducted and the comfort level, with (or pricing adjustment in light of) known risks.

Sellers in Canadian private equity transactions seek to limit liability through:

- the use of materiality thresholds and knowledge qualifiers in providing representations and warranties;
- the application of baskets and deductibles (ie, imposing minimum thresholds that must be obtained before out of pocket);
- shortened durations for representations and warranties; and
- reducing the cap on indemnification.

The duration of representations and warranties in a non-insured deal typically ranges from 12 to 24 months (with carve-outs for tax, fraud, environmental or specific representations such as fundamental representations, which can have a longer period). Following US trends, where fundamental representations used to be provided for an indefinite term, these too are restricted in time, although often longer than the general duration for other representations. As a result, sophisticated private equity purchasers have sought to expand the definition of fundamental representations beyond what was covered historically (share ownership and authority to sell) to include core zones of risk, such as intellectual property, with varying levels of success. However, in a sellers' market, as has been seen during the pandemic, the success of such an approach was more limited.

Indemnification provisions in private M&A in Canada range anywhere between 10% and 100% of the purchase price, and may even go uncapped. However, in private equity transactions, caps are typically under 25%, with more

and more deals following US trends of a lowered cap to 10% and below.

In recent years, Canada has seen a growing number of transactions involving representations and warranties insurance, especially in transactions involving private equity investors. When first introduced, indemnification provisions in purchase agreements with representations and warranties insurance policies provided a "first recourse" against the sellers (often for a value not exceeding 0.5% of the enterprise value after having applied a deductible – often in the same amount) before accessing the policy. As a result, sellers had some "skin in the game" before the policy would kick in. These limitations did not typically apply to fundamental or tax representations, or to fraud.

While many transactions still reflect this approach (with variations), the growing trend in larger private equity transactions is to have vendors benefiting from public company-style representations and warranties packages with zero recourse after closing, with buyers relying entirely on the representations and warranties insurance policy.

6.9 Warranty and Indemnity Protection

In Canada, who gives the representations and warranties in a private sale transaction (whether the target company/management or the shareholders/private equity fund) is not a crucial argument, as indemnification will come from the sellers regardless of who gives the warranties. As an institutional investor, the private equity fund will typically represent as to its share ownership, capacity and due authorisation to sell the shares, as well as antitrust thresholds, where applicable, and will work closely and diligently with management to ensure the company provides comprehensive operational representations.

A private equity seller will necessarily seek to limit liability as much as possible, thereby maximising returns for its investors within a shorter time period. However, as sophisticated buyers, funds are also accustomed to accommodating relatively robust representations and warranties on the target company, including:

- the accuracy and completeness of financial statements;
- that there are no undisclosed liabilities;
- a list of material contracts;
- that there is insurance coverage in place;
- warranties provided to customers;
- material compliance with the applicable laws for a limited lookback period;
- pending and threatened litigation;
- relationships with material customers and suppliers;
- material compliance with employment and benefits laws;
- a list of required consents, notifications and regulatory approvals;
- a list of owned and leased real property;
- compliance with environmental laws and the availability of environmental reports;
- breaches of privacy, anti-spam, cyber-risk and anti-corruption policies and laws;
- IP ownership and infringement; and
- the status of IT and information systems.

Private equity sellers will conduct a thorough disclosure exercise with management and external counsel to ensure that all statements in the representations can be confirmed, and to identify all carve-outs or disclosures required to limit the scope of the representations given in light of all known facts. In the context of transactions involving representations and warranties insurance policies, a buyer will typically require comprehensive representations and warranties, as the overall liabilities of the sellers will be limited

to a small fraction of the purchase price (sometimes with exceptions for fundamental and tax representations, fraud and special indemnities). As a result, representations and warranties are typically easier to negotiate between buyers and sellers where such policies are in place. Also, buyers will typically require a materiality scrape provision that will facilitate the determination of whether or not a breach has been made and the amount of damages incurred.

As mentioned above (in the absence of representation and warranty insurance), a private equity seller's representations will be limited by pervasive qualifiers, in time (12–24 months), by capping the indemnification (as low as possible – commonly below 10% of the purchase price), and applying de minimis thresholds such as deductibles or tipping baskets.

The contents of a data room are not used in Canada against representations and warranties; instead, a disclosure schedule that lists relevant items from the diligence conducted is annexed to and forms an integral part of the purchase agreement.

6.10 Other Protections in Acquisition Documentation

Representations and warranties insurance has become commonplace in Canadian transactions. Canadian bidders have been adopting this framework to provide a competitive edge (or to ensure they do not lose one to their US competition), and have become comfortable and familiar with the mechanics. Insurance has provided an attractive option to private equity purchasers purchasing companies from management sellers who remain engaged in the business post-closing, as the tension of possible claims is effectively eliminated and shifted to the insurer.

When first introduced, indemnification provisions in purchase agreements with representations and warranties insurance policies provided a "first recourse" against the sellers (often for a value not exceeding 0.5% of the enterprise value after having applied a deductible – often in the same amount) before accessing the policy. As a result, sellers had some "skin in the game" before the policy would kick in. These limitations did not typically apply to fundamental or tax representations, or to fraud.

However, although many transactions still reflect this approach (with variations), the growing trend in larger private equity transactions is to have vendors benefiting from public company-style representations and warranties packages with zero recourse after closing, with buyers relying entirely on the representations and warranties insurance policy.

Most of the mid-market private M&A and the great majority of the large private M&A involving private equity investors will involve representations and warranties insurance.

With the widespread adoption of representations and warranties insurance, there has been a trend towards smaller or no indemnification escrows. However, purchase price adjustment escrows continue to be used. In competitive bids and in a sellers' market, there is a growing trend of purchase price adjustment escrows being the sole recourse of the buyers against the sellers with respect to purchase price adjustments.

6.11 Commonly Litigated Provisions

While litigation does arise in private equity M&A, Canada is not as litigious in approach as its neighbours south of the border. In Canada, the court can generally order that the losing party pays the litigation fees to the winner, which in

itself is a deterrent. The most common disputes pertain to purchase price disputes, where the dispute procedure is via an independently appointed accounting firm and is generally settled before recourse to the courts. Warranties and indemnification clauses pertaining to third-party claims also lead to quite a bit of litigation (before the courts or an arbitrator, as opposed to an accounting firm).

7. Takeovers

7.1 Public-to-Private

Private equity companies consider both public and private targets in Canada, but there is considerably more volume in private company targets than public. This may be due to the relative number of attractive targets, the level of comfort the private equity has in the privatisation model and the additional level of complexity and uncertainty required in obtaining requisite shareholder approvals, and fiduciary out provisions elevating deal risk in public company transactions. The public-to-privates by private equity firms that do occur are rarely done on a hostile basis; generally, the negotiations are friendly and the transaction is ultimately supported by the target board (and significant shareholders, where possible). As public markets continue to struggle in 2023, there may be more opportunistic acquisitions by private equity firms.

In a public-to-private deal, the target board (or a special committee of the board formed of uninterested members in the transaction) is a key actor in the negotiation process. The committee's recommendation, and the board's ultimate recommendation, to the company shareholders, together with fairness opinions (and formal valuations, where required) are essential to getting these deals across the finish line.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Holdings of more than 10% of the equity of a public company in Canada trigger the filing of an early warning report, which provides public disclosure of the shareholdings of the holder. Holders of more than 10% of the equity of a public company in Canada are considered "insiders". An early warning report is comprised of the dissemination of a press release and the filing of an early warning report form on the issuer's profile containing prescribed information on SEDAR (the System for Electronic Document Analysis and Retrieval at www.sedar.com – the website used by Canadian reporting issuers to file public securities documents with the Canadian Securities Administrators).

Crossing the 10% equity holding threshold of a public company also requires concurrent insider report filings on SEDI (the System for Electronic Disclosure by Insiders at www.sedi.ca – the browser-based service for the filing and viewing of insider trading reports and required by the Canadian provincial securities regulators). An insider report outlines the current holding of insiders of an issuer. Insider reports are typically required to be updated within five business days of any changes to the holdings of an insider (a director, officer or 10%+ equity holder of the issuer). The use of derivatives and options to increase economic exposure is a key consideration when determining if a private equity firm has triggered a public disclosure obligation.

7.3 Mandatory Offer Thresholds

Subject to limited exemptions, the threshold for triggering Canadian takeover bid rules is the acquisition of a "bright line" 20% test. If a purchaser acquires 20% or more of a class of voting securities of the target, whether alone or working in conjunction with other parties (a pur-

chasing group), the purchaser will be required to offer to purchase the shares of all of the registered shareholders of the same class, unless an exemption is available.

7.4 Consideration

Both cash and share deals (or a combination thereof) can be used as consideration. However, the issuance of shares is most common where the purchaser is a public entity itself, as valuation is facilitated with public share prices. As such, private equity transactions tend to be cash deals.

It should be noted that there has been a growing use of earn-out provisions in an effort to bridge valuation gaps between buyers and vendors. For public company take-private deals, these can take the form of contingent value rights (CVRs – securities that provide for shareholders' right to get certain additional benefits/payments upon the occurrence of specific events, such as earning thresholds, etc, over a period of time).

7.5 Conditions in Takeovers

Takeover bids in Canada can be subject to conditionality, but cannot be conditional on financing. Unlike the UK, for instance, conditions beyond regulatory approvals may be negotiated.

Other privatisation structures can be presented to shareholders at a meeting, and if the requisite approvals are obtained (66.66%, as well as any "majority of minority" that may be required), the transaction may proceed in accordance with the terms of the negotiated agreement. In some cases, this is done pursuant to a court-sanctioned plan of arrangement (similar to the UK scheme), while in other cases it is completed by an amalgamation.

A number of privatisations completed by private equity-backed buyers in Canada are for issuers that have not conducted lengthy strategic processes and where the shareholders have a general appetite to exit quickly. In such cases, the purchasers may succeed in obtaining more favourable (and more certain) protections, including reverse break fees, force the vote provisions, non-solicitations and the right to match any unsolicited superior offer. However, in more competitive processes where the public target is known to be "in play", the seller may push to have protections of its own.

7.6 Acquiring Less Than 100%

In Canada, there is a 50% minimum tender requirement for all formal bids. Bids must be open for a minimum of 105 days (subject to the target's ability to shorten the period under certain circumstances). If at the expiry of the initial bid period the minimum tender requirements and all other conditions of the bid have been satisfied or waived, the purchaser must extend the period for at least ten days to allow additional shareholders to tender. At the expiration of the bid period, the purchaser takes up the shares and pays the tendering shareholders. If 90% of the shares have been tendered and taken up, the shareholders of the remaining 10% can be forced to tender their shares through statutory mechanical "squeeze-out" provisions.

Where fewer than 90% but more than 66.66% of the shares (or 75% in the case of some British Columbia corporations) have been taken up, the purchaser must proceed to a second-stage "squeeze-out" transaction to purchase the remainder, which generally requires the approval of two-thirds (or 75% in the case of some British Columbia corporations) of the shareholders and possibly a majority of the minority shareholders.

7.7 Irrevocable Commitments

It is common (and nearly always a prerequisite in the case of private equity-backed privatisations) to obtain lock-ups from principal shareholders, if accessible. Undertakings may be "hard" (no out) or "soft" (out for superior offer) for major shareholders, although it is more difficult to obtain hard lock-ups in competitive processes. As private equity-backed privatisations tend to be "friendly", directors and officers will also be asked to execute soft lock-ups. Under Canadian securities laws, shares tendered to the bid can be used by the buyer to vote in favour of the second stage squeeze-out.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentive plans are commonly used in Canadian private equity investments. Stock option plans are most frequently implemented (with straight time vesting provisions and/or performance vesting criteria). The option pool is typically anywhere between 5% and 20% of the outstanding common equity.

Stock options have historically been used by private equity firms in Canada as an effective means of incentivising management teams. The tax benefit of stock options for members of management may be limited if the corporation issuing the options is not a CCPC.

8.2 Management Participation

Most private equity investors in Canada focus on strong management teams when identifying attractive targets. Where a management group is included in the selling parties, rollover arrangements for a minority position are considered, and such members execute a shareholders' agreement with the private equity and any other institutional investors. Sweet equity is not common for companies of the size and stage a Canadian private equity fund is typically targeting.

Investments may be in the same category of shares as the institutional investor, or distinct, and may be voting or non-voting. Notwithstanding scenarios where existing management continues to hold a significant stake in the company, private equity investors will typically impose or structure the management investment so as to facilitate decision-making and approvals required to proceed with the private equity fund's expansion strategy without management consent or blocking such decisions. These mechanics may include non-voting shares, shareholders' agreement undertakings, or the appointment of agents or proxies for such management shareholders.

8.3 Vesting/Leaver Provisions

Leaver provisions are negotiated, and different private equity funds take different approaches to management equity in cases of termination and departure. Leaver provisions are almost universally found in stock option plans, but are more nuanced and negotiated in the case of shareholders' agreements.

Generally speaking, unvested stock options will terminate concurrently with the last date of employment, whereas vested stock options will remain exercisable for a period of time following the last date of employment (unless the employee has been terminated for cause). In such circumstances, management employees may become shareholders subject to the shareholders' agreement in place, but the company may also have the right to "call" such shares in the case of the employee leaving the company, using a predetermined pricing arrangement equal to the fair market value, or some discount

thereon depending on the circumstances of departure.

Similarly, although less consistently, the shareholders' agreement may provide the company with the right to "call" any shares held by management in the case of termination or departure using predetermined pricing arrangements (again, varying depending on the circumstances of departure). In some cases, particularly where management continues to hold a significant stake in the company, management shareholders may negotiate the right to "put" their shares, forcing the company (or other shareholders) to redeem or purchase the holder's shares in certain cases of departure, using predetermined pricing arrangements. In the absence of specific leaver provisions, management shareholders are bound by obligations of (and benefit from rights accorded to) other shareholders, regardless of their status as an employee.

Vesting provisions vary from one stock option plan to another, with time vesting over a period of up to five years being the most common. However, performance vesting criteria (based on EBITDA, for example) are also applied. Typically, unvested options will be accelerated upon the occurrence of a liquidity event.

With the growing number of US private equity funds investing in Canada, there is a growing trend of having a portion of the stock options granted to managers vesting only upon the private equity fund having received a multiple of its capital in the target (for example, 1x, 2x or 3x), provided that management is still employed by the target at the closing of a liquidity event.

8.4 Restrictions on Manager Shareholders

Non-competition covenants are enforceable in Canada (except in Ontario as it relates to non-competition clauses found in employment contracts of non-managerial staff) if they are crafted appropriately and are reasonable in terms of duration, scope and territory. Non-solicitation covenants and non-disparagement undertakings are also customary. Non-competition covenants are common in business acquisitions but are unenforceable in the province of Ontario in the case of mere employees (ie, they are only enforceable for individuals in positions of president or chief level positions and for executives who are shareholders in relation to a sale of business).

In an employment agreement, the upper limit for a top executive in terms of a non-compete is typically up to two years. However, most enforceable covenants of late have been in the 12-month range. A private equity purchaser will often seek to obtain a seller non-compete from exiting management shareholders (in each case in their capacity as shareholders) for the following reasons:

- employment non-competes are no longer permitted in certain provinces; and
- in provinces where employment non-competes are still permitted, the scope of protection under a shareholder non-compete is generally for a longer period than non-competes tied to employment.

Since 23 June 2023, the Competition Act has included a criminal provision prohibiting unaffiliated employers from agreeing "to not solicit or hire each other's employees". As with the general cartel provisions, this new provision includes an ancillary restraints defence. According to recent

guidance issued by the Bureau, this provision does not require that the unaffiliated employers be competitors or potential competitors, which is unlike the framework that applies to the general conspiracy provisions in the Competition Act. This guidance also makes it clear that the new provision applies only to agreements to not solicit or hire "each other's" employees, with the result that "one-way" restraints (ie, restraints that only apply to one employer) are not subject to the new provision. However, when there are separate agreements between two or more unaffiliated employers that result in reciprocating promises to not poach each other's employees, then the Bureau may take enforcement action.

Accordingly, non-solicit clauses or other employee-related provisions in transaction agreements should have regard to this new no-poaching prohibition. In particular, provisions that go beyond what may be typical in duration and scope should be considered closely to ensure they are reasonably necessary to achieve the objective of the broader transaction agreement.

8.5 Minority Protection for Manager Shareholders

Management shareholders do not typically benefit from robust minority protection, though they will typically have some limited protection under corporate statutes through majority and super-majority shareholder approval requirements as well as remedies in the face of oppressive conduct against the corporation.

Anti-dilution protection (pre-emptive rights) may or may not be accorded to all shareholders on a pro-rata basis, although this is the most likely to be accommodated by private equity partners.

It is rare for a minority management position to have veto rights, which are typically in favour of the private equity investor and any other institutional investors holding material positions. If a founding member of management continues to hold a substantial percentage of equity, certain veto rights might be granted, but such rights are highly dependent on the circumstances.

Similarly, whether or not a management team (either collectively or certain executives) has board appointment rights depends on the proportionate control of the management stake. Where management is on the board, this is most commonly tied to the position of the CEO.

The same is true of exit rights. It is rare to see management have any right or control of the private equity exit. Shareholders' agreements tend to be crafted to provide for a "drag" provision for all shareholders. A management shareholder would need to have a considerably large percentage of the company for a private equity investor to entertain the idea of giving this power to management.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

Private equity funds typically seek maximum control over their investment, in terms of board oversight and veto rights. The board is customarily controlled (majority-composed) by the lead private equity investor. Veto rights requested can include a variety of items, including:

- consents required as to any proposed corporate restructurings, acquisitions or divestures;
- the incurrence of additional debt;
- the issuance of additional equity;
- budget approvals;
- changes to key management; and

• a change to the head office location.

Information rights are also regularly provided to institutional investors, including quarterly financial reporting, management reports and forecasts, details on pending or threatened litigation and any other data required for the fund's tracking.

9.2 Shareholder Liability

Courts in Canada will generally not pierce the corporate veil, except in very unusual circumstances, such as the company being used to shield against illegal or fraudulent acts.

10. Exits

10.1 Types of Exit

Sales to foreign (mostly US) private equity firms have dominated recent exits in Canada. Private equity exits through M&A and secondary buyouts have been the most prevalent.

While dual track processes are sometimes considered, private equity funds have been opting for faster exits with immediate liquidity, without the leeway required to set up for a public offering. IPO exits of private equity-backed portfolio companies remain significantly decreased, with no IPO exits in 2022 and one in 2023.

Recapitalisations and continuation vehicles are options on the table in the current climate as private equity sellers' traditional exit strategies are seeing lower valuations and challenging public market opportunities.

10.2 Drag and Tag Rights

Private equity funds will typically include sophisticated drag mechanisms in their shareholder agreements to ensure that they can force an exit on the shareholders of a portfolio company.

In practice, these provisions rarely have to be enforced as private equity funds will rely instead on the co-operation and willingness of minority investors to participate in the sale. There is no typical drag threshold in Canadian jurisdictions, other than in the public company context (of 90% + tendering to a bid under a statutory squeeze-out or more than 66.66% but less than 90% tendering to a bid for a second stage squeeze-out). In the private company context, this is a contractually negotiated threshold.

Tag rights are sometimes granted to minority shareholders (including management), especially in the case of change of control transactions. There is no typical tag threshold in Canada.

However, institutional co-investors will be required to fully tag along with any sale of the private equity sponsors (subject to certain limited exceptions).

10.3 IPO

In addition to any escrows that may be required by the applicable stock exchange on which the target is to be listed (typically applicable to companies with less than CAD100 million market cap), the underwriters will typically request lock-ups from private equity shareholders who do not sell concurrently with the IPO for a period of 60 to 180 days following the offering. Arrangements are sometimes implemented to provide for board nomination rights and registration rights (secondary prospectus sales).

Trends and Developments

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Fasken is one of Canada's largest business law firms, providing strategic advice on private equity transactions. The private equity group comprises more than 200 lawyers, who offer knowledge through every stage of the investment cycle, from fund formation, LBOs and take-private transactions, co-investments, portfolio add-ons, tuck-ins and other M&A through to liquidity exits via strategic sale, auction processes or IPO. The group regularly acts for Canadian and international private equity funds, pension funds and other institutional investors, as well as a broad range of portfolio companies and founder-owned and operated businesses in a variety of industries. Fasken has renowned industry experience across the industrial, technology, retail, financial services, infrastructure and projects, mining, and energy and climate sectors, amongst others. As a full-service firm, Fasken also offers leading practice groups covering fund formation, M&A, banking, capital markets, governance, ESG, tax, competition, marketing and foreign investment, regulatory, privacy and cybersecurity, labour and employment, litigation, and insolvency and restructuring, making the firm a true "one-stop shop" for clients' legal needs.

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CANADA TRENDS AND DEVELOPMENTS

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Introduction

While economic uncertainty, rising inflation and interest rates and other macroeconomic pressures led PE to deploy capital cautiously and sparingly in 2023 (focusing instead on "value creation" within existing investments), the first half of 2024 has shown signs of a subtle recovery. Smaller deals and a significant surge in add-ons combined with a smaller number of sizeable buyouts announced are demonstrating a hopeful rebound for Canadian PE. Canadian PE saw a continued focus in cleantech investments, matching 2022 record highs, and exit activity via M&A in the first quarter of 2024 surpassed exit value in all of 2023.

This summary covers private equity deal activity for 2023 and the first quarter of 2024, common Canadian deal structures and Canadian legal considerations.

2023 Deal Activity

Traction in Canadian PE in 2023 ended in radio silence, with the fourth quarter recording the lowest investment value in history. Annual investment totalled CAD9.7 billion in comparison to CAD10 billion in 2022. This lead to a decrease in large PE deals, resulting in 84% of all transactions valued under CAD25 million. Québec and Ontario remained the most active provinces for PE activity in Canada, accounting for 55% and 26% of all deals, respectively.

Q1 2024 Deal Activity

Q1 of 2024 saw a significant increase in transactions as a result of inflation softening and an expected decrease in interest rates. CAD4 billion was invested across a total of 140 deals in Q1 and, despite a decrease in deal volume, deal values increased by 52% from the fourth quarter of 2023.

The automotive and transportation industry set a blistering pace in Q1 with CAD1.4 billion in deal value across six deals. A continued focus on deals in the clean tech industry added to the increase in deal volumes.

Private Equity Exits

Canadian PE exits via M&A significantly decreased in 2023, indicative of manager decisions to prolong their investments for more favourable valuations. The majority of exits were completed through M&A while a quarter of exits were completed by secondary buyout.

Continued volatile public markets continued throughout 2023; there was only 1 PE backed IPO exit in 2023.

Private Equity Deal Structure in Canada

The most common deal structures used for private equity transactions for public take privates are the plan of arrangement and takeover bid. Private company transactions are generally structured as share deals or asset deals depending on tax and liability considerations. There follows a brief discussion of these structures and current trends in these structures.

Plan of arrangements

A plan of arrangement is the preferred transaction structure used to implement negotiated public merger and acquisition transactions in Canada. A plan of arrangement is a court-sanctioned process (similar to the UK scheme of arrangement) used when both parties to a transaction are "friendly" and willing to enter into an agreement subject to negotiations and requisite approvals. When completing a transaction via a plan of arrangement, the whole process generally takes 50-60 days, subject to third-party and regulatory approvals.

Takeover bids

Conversely, few private equity deals are conducted by way of takeover bids (whether friendly or hostile) in Canada. Regulatory hurdles, complex compliance requirements for non-Canadian bidders, as well as delays and costs associated with possible second step (squeeze-out) transactions are major deterrents. A formal takeover bid is required under Canadian securities laws when an acquirer acquires 20% or more of the securities of a class of a target company.

Key elements of a Canadian takeover bid include: (i) offering identical consideration or an identical choice of consideration to all holders of the same class of securities; (ii) bidders being prohibited from taking up securities under a bid unless the bid received tenders of more than 50% of the securities of the class subject to the bid, excluding those beneficially owned by the bidder; (iii) keeping the bid open for a period of 105 days subject to certain exceptions; and (iv) launching the bid without a condition for financing as part of the offer.

Canadian hostile bids are not commonly used by private equity firms.

Share deals

Unless there is a significant known liability that needs to be carved out through structuring as an asset sale, share purchase transactions are the most common form of private equity structure in Canada given the tax advantages to the seller (capital gains treatment) and the reduced legal complexity. Terms of the purchase agreement can vary significantly depending on the private equity player backing the purchaser and the strategic importance of the acquisition to an existing portfolio or the creation of a new platform, as applicable. In a competitive auction, the terms tend to be more balanced and seller-friendly provisions (for example, shorter duration and smaller amount of indemnification holdback, acceptance of more pervasive qualifiers in the representations and warranties, shorter lists of closing conditions, and a more limited indemnification regime) and the use of representation and warranties insurance are more prevalent.

Trends in Deal Terms

Minority investments

Approximately 32% of private equity funds invested in Canada throughout 2023 were minority investment deals.

Approximately 20% of deals had structured consideration using a combination of cash and management rollover, to bridge the valuation gaps and to ensure continuity of business by retaining key personnel and their expertise, resulting in a reduced need to obtain additional financing and cash up front.

Earn-outs

Parties continue to rely on earn-outs or other forms of contingent consideration. In 2023, 32% of deals were reported to contain earn-outs.

Representation and warranties (R&W) insurance and indemnification

Most of the mid-market private M&As and the great majority of the large private M&As involving private equity investors will involve representations and warranties insurance. When first introduced, indemnification provisions in purchase agreements with representations and warranties insurance policies provided a “first recourse” against the sellers (often for a value not exceeding 0.5% of the enterprise value after having applied a deductible (often in the same amount)) before accessing the policy. As a result, sellers had some “skin in the game” before the policy would kick in. These limitations did not

typically apply to fundamental or tax representations or to fraud.

Private equity buyers are increasingly relying on representations and warranties insurance to provide vendors with full consideration with minimal escrow and indemnification provisions. Although many deals continue to provide for indemnification escrows and robust indemnification clauses, the duration and scope have been diminishing in recent years. In fact, we are seeing a growing trend, particularly in competitive situations, of purchase agreements with public company-style representations and warranties packages with zero recourse after closing; however, this trend has slowed down in 2023 through to 2024 given recent market conditions. In contrast, transactions with zero post-closing recourse are not typical for strategic corporate buyers.

Legal Considerations in Canadian Private Equity Deals

Antitrust/competition considerations

In recent years, competition/antitrust enforcers around the world, including Canada, have taken a marked interest in private equity deals. This is part of a broader global trend towards tougher merger enforcement. As part of this enforcement effort, the Competition Bureau (the “Bureau”) now routinely requests information about a private equity investor’s minority shareholdings during the merger review process, including information concerning (i) any shareholders with at least a 10% direct or indirect interest in the applicable fund and (ii) any companies in which the applicable fund has at least a 10% direct or indirect interest. Further information may be requested regarding any interest held by these shareholders and companies that compete with the target.

Private equity firms that take ownership positions (controlling or minority) in portfolio companies that are competitors have been subject to heightened scrutiny. By way of example, in 2019 the Bureau sought to unwind a completed merger involving the acquisition of Aucerna (a company offering valuation and reporting software to oil and gas producers) by Thoma Bravo, a private equity firm, in circumstances where Thoma Bravo already owned a competing business to Aucerna. The litigation was subsequently settled by way of a registered consent agreement, after Thoma Bravo agreed to divest a major business within its control to a purchaser acceptable to the Bureau.

Private equity investors may identify an industry of interest and contemplate a series of acquisitions over time to build sufficient scale and efficiency. In these circumstances in particular, care should be taken to develop credible longer-term arguments regarding market definition, viable and effective remaining competition, vertical issues and efficiencies that will substantiate a series of investments. Such credible and consistent arguments will be helpful before the Bureau and, if ultimately necessary, Canada’s Competition Tribunal.

Finally, there is a greater focus in Canada on scrutinising foreign investments in Canadian businesses on national security grounds, particularly investments involving foreign state-owned enterprises. A consequence of this focus is greater scrutiny of private equity investors that may have ties to or significant investment from foreign SOEs.

Tax Considerations

Below is a general summary of certain Canadian income tax considerations relevant to private

equity investments in Canada by non-Canadian investors (ie, "foreign investors").

Excessive interest and financing expenses limitation

The 2021 Canadian Federal Budget expressed a concern with the erosion of the Canadian tax base due to deductions for interest paid disproportionately by Canadian members of multinational groups on third-party borrowings and paid by Canadian members on related party borrowings to group members located in low-tax jurisdictions. On 20 June 2024, Bill C-59, which includes the legislation to implement the excessive interest and financing expenses limitation (EIFEL) rules, received royal assent, thus making the EIFEL rules applicable for taxation years beginning on or after 1 October 2023. The rules limit the deduction by a Canadian corporation of interest and financing expenses (IFE), net of interest and financing revenues, to a fixed percentage of the company's adjusted taxable income that is derived from the company's tax EBITDA. The fixed percentage starts at 40% for taxation years beginning on or after 1 October 2023, and before 1 January 2024, decreasing to 30% for taxation years beginning thereafter. There is also a "group ratio" rule applicable in certain cases, allowing a higher ratio. The 2024 federal budget proposes to amend the EIFEL rules to provide for an elective exemption relating to purpose-built rental housing, effective for taxation years beginning on or after 1 October 2023. Such amendment was not included in Bill C-59 and draft legislation to implement this exemption has not yet been released.

Very generally, a company's tax EBITDA is equal to such company's taxable income before taking into account any interest expense, income tax and deductions for depreciation and amortisation, each as determined for tax purposes. Tax EBITDA excludes inter-corporate dividends from Canadian or foreign affiliates that qualify for certain deductions. Interest expenses include other financing-related expenses and amounts economically equivalent to interest but would not include interest that is otherwise not deductible for tax purposes, such as interest denied under the thin capitalisation rules (see comments above regarding Canada's thin capitalisation rules). Interest expenses and interest income on debts between Canadian members of a corporate group would also generally be excluded from the new rules.

The rules will apply to all Canadian corporations and trusts, except for (i) CCPCs that, together with any associated corporations, have taxable capital employed in Canada of less than CAD50 million; (ii) groups with Canadian net IFE of CAD1 million or less; and (iii) certain groups that operate almost entirely in Canada and have no significant foreign affiliates. The rules will indirectly apply to partnerships, owing to the inclusion of interest expenses and revenues that are recognised in a partnership (prorated on the basis of the corporation's or trust's share of partnership income).

Interest denied under the EIFEL rules can be carried forward indefinitely by a taxpayer to the extent of its excess capacity for a given taxation year or can be effectively carried-back for up to three years. Also, a company that is part of a group and that has excess capacity to deduct interest under the EIFEL rules in a given taxation year or in the three immediately preceding years can generally transfer such available capacity to other Canadian group members.

Use of a Canadian acquisition company

In many situations, a foreign investor will establish a Canadian company for the purpose of

purchasing the shares of a Canadian target company to achieve certain tax benefits. Certain jurisdictions in Canada do not require any Canadian residents to be directors of a corporation, which can prove attractive to certain foreign investors.

To the extent the purchase price for the shares of the Canadian target company is funded by the foreign investor with equity ("paid-up capital" for Canadian tax purposes), the Canadian acquisition company will, generally speaking, be able to return such paid-up capital free of Canadian withholding tax in the future, provided it can satisfy applicable corporate solvency tests. See comments below regarding Canada's dividend withholding tax.

If the Canadian acquisition company borrows money to pay a portion of the purchase price, it may be possible to offset the interest expense on such borrowing with the profits earned by the Canadian target company by amalgamating (a Canadian form of merger) the Canadian acquisition company and the Canadian target company after the completion of the purchase of the target. See comments below regarding Canada's thin capitalisation rules and interest withholding tax.

Where a Canadian target company owns subsidiaries outside of Canada, it may be more tax efficient to move the ownership of such subsidiaries out of Canada after the completion of the acquisition. Subject to complying with technical tax requirements, it may be possible for a Canadian acquisition company to elect to increase or "bump" the cost base of the shares of such subsidiaries from the Canadian target company's historic cost base in the shares up to the fair market value of such shares on the date the Canadian target company was acquired by the Canadian acquisition company – this is done in the context of the winding-up (or amalgamation) of the Canadian target company into the Canadian acquisition company.

Management rollover

Canadian tax rules do not permit a Canadian resident shareholder of a Canadian corporation to exchange its shares for shares in the capital stock of a non-Canadian corporation on a tax-deferred (or rollover) basis. A rollover may, however, be possible in circumstances where the shareholder receives shares in the capital stock of a Canadian corporation.

In some cases, investors will implement an exchangeable share structure which allows management members (or other Canadian resident shareholders) of a Canadian target company to sell their shares of the Canadian target company on a rollover basis for "exchangeable shares" issued by a Canadian corporation controlled by the foreign investors. The terms and conditions of the exchangeable shares and certain ancillary agreements permit the holders of exchangeable shares to exchange such shares in the future for shares of a foreign entity (ie, the parent company of the business). Since this latter exchange will be a taxable event for the Canadian resident shareholders, the exercise of exchange rights does not usually occur until the shareholders are ready to dispose of their investment so that the sale proceeds can be used to cover their Canadian tax liability.

Foreign intermediaries and treaty shopping

Canada has been an active participant in the Base Erosion and Profit Shifting (BEPS) project of the Organisation for Economic Co-operation and Development (OECD). In connection with the BEPS project, Canada has ratified the Multilateral Instrument (MLI) effective 1 December

2019, and adopted the minimum standards proposed by the OECD.

In the past, foreign investors have commonly invested in Canada through corporate holding companies in Luxembourg or the Netherlands, for example. However, this practice has been impacted by the provisions of the MLI, which has introduced specific treaty shopping restrictions to most of Canada's tax treaties – but, notably, not the Canada-United States Tax Convention (the Canada-US Treaty), which already includes limitation-on-benefits provisions. Care should be taken when investing in Canada through a foreign holding company to ensure desired treaty benefits are available.

Dividend withholding tax

Dividends paid by a Canadian company to a shareholder that is a non-resident of Canada are generally subject to a withholding tax of 25%.

Dividend withholding taxes may be reduced where the recipient shareholder is a resident of a jurisdiction with which Canada has a tax treaty. For example, dividends paid to a US resident that qualifies for treaty benefits are subject to a withholding tax rate of 15%. The Canada-US Treaty provides an even lower withholding rate where the US resident shareholder receiving dividends is a corporation that owns 10% or more of the voting stock of the Canadian corporation.

Interest withholding tax

Generally speaking, interest paid by a Canadian resident corporation to an arm's length non-resident lender should not be subject to Canadian withholding tax. Interest paid to a non-arm's length non-resident lender, however, is subject to a 25% withholding tax. That being said, Canada's tax treaties typically reduce the withholding tax imposed on non-arm's length interest payments to 10%. Notably, however, the Canada-US Treaty generally provides that US resident lenders are exempt from Canadian interest withholding tax even where such lenders are non-arm's length with the Canadian borrower.

Thin capitalisation

Canada's thin capitalisation rules may limit interest deductibility for Canadian companies with respect to certain loans from specified non-resident shareholders. Generally, interest on such loans is not deductible for Canadian tax purposes where the Canadian corporation's debt-to-equity ratio exceeds 1.5-to-1. For these purposes the "equity" is the aggregate of the Canadian corporation's retained earnings, contributed surplus and paid-up capital, computed at different times, that are attributable to specified non-resident shareholders. A "specified non-resident shareholder" is a non-resident that holds shares representing 25% or more of the outstanding shares of the Canadian company, by votes or value, or does not deal at arm's length with any such shareholder.

Exit From Canadian investment

Generally speaking, capital gains realised by a foreign investor upon a disposition of shares in the capital stock of a Canadian company are not subject to Canadian tax unless the shares are "taxable Canadian property". Canadian private company shares will be considered taxable Canadian property if, at any time during the preceding 60 months, the shares derived their value principally from real property situated in Canada, timber resource properties or Canadian resource properties.

Canadian tax treaties may offer relief in respect of Canadian capital gains taxes arising on the disposition of taxable Canadian property in limited circumstances. However, regarding Cana-

dian tax treaties subject to the MLI, a 365-day look-back rule may find application in allowing Canada to tax capital gains realised by non-resident persons on shares or other interests whose value is primarily attributable to real property in Canada.

Trends for Energy, Infrastructure and Resource Projects

Two important and recent trends affecting Canadian energy and infrastructure investments and transactions are the increasing number of deals in sectors involving private equity and other financial buyers and major projects and transactions involving Canadian indigenous groups. In some high-profile cases, the two trends are evident in the same transaction.

Private equity interest and deal flow in Canada is increasing, with private equity investment focusing on opportunities in the Canadian energy and infrastructure sectors. Given the status and importance in Canada of indigenous rights and title affecting many of these sectors and projects, major transactions or projects in Canada increasingly consider or involve First Nations, or groups of First Nations, often as a minority interest in the business or transaction structure, with the intent of aligning business, reconciliation and other interests. The two trends are combining to create unique opportunities and arrangements in Canada, including transaction and business structures involving private equity/indigenous co-ownership and business models.

Employee Stock Options

Stock options have historically been used by private equity firms in Canada as an effective means of incentivising management teams. In Canada, stock options are considered part of employment income, and taxed accordingly. Further, they are taxed at the time of exercise rather than at the time of grant. Given these attributes, stock option plans have been widely used within portfolio companies.

Under the current stock option rules, a taxable benefit is added to the employee's income at the time of exercise, to the extent the fair market value of the underlying shares exceeds the exercise price specified in the option agreement. However, the employee is entitled to claim a deduction in the amount of 50% of the taxable benefit provided that at the time of the grant, the options are not "in-the-money" and, generally, common shares are issued upon the exercise of the options.

That being said, employees of certain corporations are subject to a CAD200,000 annual vesting limit (based on the fair market value of the underlying shares at the time the options are granted) regarding the eligibility of their employee stock options granted on or after 1 July 2021, to the 50% deduction described above. This limit was enacted by the Canadian government to prevent executives of large, mature companies from taking advantage of the rules as a preferred form of compensation instead of achieving the policy objective of supporting younger and growing Canadian businesses. More specifically, this vesting limit does not apply to employee stock options granted by either Canadian-controlled private corporations (CCPCs) (very generally, Canadian private corporations that are not controlled by one or more non-resident persons and/or public corporations), and non-CCPCs that have gross revenue of CAD500 million or less as reported in their most recent financial statements, or in their group consolidated financial statements if reported on a group basis.

CBCA Disclosure of Beneficial Ownership

Companies governed by the federal business statute in Canada – the Canada Business Corporations Act (CBCA) – are required to maintain a detailed shareholder register that reflects all individual shareholders having significant direct or indirect control over a corporation. The CBCA requires private corporations to include information about individuals who hold "significant control" over a corporation. The number of shares held by an individual is deemed "significant" if it (i) carries 25% or more of the voting rights attached to all of the corporation's outstanding shares, or (ii) is equal to 25% or more of all of the corporation's outstanding shares measured by fair market value. Practically speaking, private equity funds often hold controlling positions (in terms of percentage owned de jure or de facto through shareholder arrangements) in their portfolio companies governed by the CBCA and should therefore be prepared to provide additional information about their controlling interests.

Conclusions for the Remainder of 2024

While high interest rates and other macroeconomic pressures remain prevalent, expectations are starting to set for a stabilising inflation market, fuelling deal activity in the beginning of 2024 that is expected to persist throughout the year. Many managers are facing pressures to provide meaningful returns on existing assets, forcing some sale processes, and the same closed-end funds are faced with looming capital deployment deadlines. Deals will happen.

CAYMAN ISLANDS

Trends and Developments

Contributed by:
Julian Ashworth, Iain Anderson, Alex Howard and Oliver Quarmby
Maples Group

The **Maples Group** through its leading international law firm, Maples and Calder, advises global financial, institutional, business and private clients on the laws of the British Virgin Islands, the Cayman Islands, Ireland, Jersey and Luxembourg. With offices in key jurisdictions around the world, the Maples Group has specific strengths in the areas of corporate commercial, finance, investment funds, litigation and trusts. Maintaining relationships with leading legal counsel, the Group leverages this local expertise to deliver an integrated service offering for global business initiatives. For more information, please visit: maples.com/services/legal-services.

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Private Equity Trends and Developments in the Cayman Islands

The first half of 2024 has seen private equity capitalising on the strong recovery of the financial markets following a period of prolonged market volatility, sustained high interest rates and continued inflationary pressures, with the second quarter of 2024 seeing the highest level of private equity activity in two years. The significant surge in the number of deals, and deal value, reflects confidence in the financial markets and a clearer macroeconomic outlook, which is driving portfolio growth.

During this period of growth, sponsors have continued to look to the Cayman Islands when structuring and offering private equity products that provide strategies tailored to the current market environment, including technology, infrastructure, credit opportunities, market dislocation and special situations opportunities funds and products with regional or focused investment mandates, including environmental, social and governance strategies.

The Cayman Islands continues to be well-positioned to respond to the fast-paced and growing private equity sector, and to retain its pre-eminent offshore position, due to its legislative and regulatory framework, tax-neutral status, flexible structuring options, respected legal system developed from English common law and experienced and responsive service providers coupled with broad market familiarity with Cayman Islands structures.

Regulatory developments

The most notable investment fund-related regulatory development in the Cayman Islands in recent years has been the introduction and implementation of the Private Funds Act, which provided for registration of closed-end collective investment vehicles with the Cayman Islands Monetary Authority (CIMA). More than 17,000 investment funds are now registered under the Private Funds Act. Cayman Islands regulation is generally fund-level focused, and there is no requirement for a non-Cayman Islands manager of a private fund domiciled in the Cayman Islands to be regulated in the Cayman Islands. Most managers of private funds are not domiciled in the Cayman Islands and are regulated by various onshore regulators, such as the US Securities and Exchange Commission, the UK's Financial Conduct Authority, the Hong Kong Securities and Futures Commission, the Monetary Authority of Singapore or the Japanese Financial Services Agency. A Cayman Islands-registered manager would be subject to oversight by CIMA and required to have sufficient substance in the Cayman Islands with reference to its business activities.

Within this regulatory framework, sponsors, allocators and investors are able to legislate their own contractual arrangements, which is particularly helpful as strategic investors seek alternatives to traditional co-mingled fund structures and vehicle types.

Alternative structures and the Cayman Islands

The Cayman Islands' offering is well-positioned for alternative structures, ranging from separate accounts and funds-of-one through to "permanent capital" structures and other strategic transaction structures, such as end-of-life liquidity options, continuation vehicles and general partner minority equity stake deals.

While the Cayman Islands is most commonly associated with the establishment of private equity funds, whether main, feeder/blocker, parallel, alternative investment or co-investment

vehicles, there continues to be a strong demand for Cayman Islands structures in transactional contexts, particularly buy-out and secondary transactions, including as management holding vehicles.

The nature, scope and volume of work being undertaken in the Cayman Islands gives rise to a number of trends and developments that reflect emerging technologies and work practices, a mature funds industry and the multi-jurisdictional dimension of offshore practice.

Fund structuring

A key reason for the jurisdiction's success is the range of Cayman Islands vehicles that are available to sponsors/managers, enabling them to structure closed-end fund products in a manner that satisfies the diverse profile of investors domiciled in geographically disparate regions.

The most popular Cayman Islands-domiciled vehicles for structuring investment vehicles are:

- exempted limited partnerships (ELPs);
- exempted companies; and
- limited liability companies (LLCs).

The use of Cayman Islands LLCs, similar to the Delaware variant, introduced in mid-2016, has continued to be popular as a flexible structuring vehicle, with more than 5,150 Cayman Islands LLCs now being registered.

The Cayman Islands Limited Liability Partnership (LLP), available for registration since November 2020, possesses the flexible features of a general partnership but has the additional benefit of a separate legal personality and affords limited liability status to all its partners. This vehicle provides an additional structuring option and may be suitable for general partner, fund-of-funds or holding partnerships.

The popularity of exempted companies and ELPs generally continues to be unaffected by the introduction of LLCs and LLPs. By way of illustration, there has been consistent year-on-year growth in the number of ELPs in existence.

There are, however, nuanced regional differences in the types of vehicles being used for private equity mandates. By way of example, the preferred investment vehicle for many Japanese investors continues to be the Cayman Islands unit trust.

North American and European markets

In the North American and European markets, most primary, feeder, parallel, alternative investment and co-investment vehicles are formed as an ELP unless a tax blocker is required.

In onshore-offshore fund structures, the ability to provide symmetry between the offshore fund vehicles and their equivalent onshore counterparts (notably Delaware and Luxembourg limited partnerships) can lead to greater ease and cost efficiency of fund administration, as well as pass-through tax treatment, and has helped to better align the rights of investors between the different vehicles in a fund structure.

The exempted company is less regularly employed as a fund vehicle, other than with respect to certain types of target investors and with reference to certain assets. The key feature of being a corporate vehicle with a separate legal personality has led to this type of vehicle being most commonly used as a general partner, manager, blocker or holding vehicle (although one of the exempted company variants, the segregated portfolio company, can be an attractive option

for managers targeting certain Middle Eastern-based or family office investors).

The LLC has been an appealing alternative for general partner, upper-tier, manager and co-investment vehicles. The absence of share capital (and the absence of the need to maintain a share register), combined with the ability to intuitively track and record the capitalisation of an LLC and its distributions, has also led to LLCs being attractive for blocker, aggregator and holding vehicle applications. Because a member is not required to make a contribution but may benefit from profit allocations, the LLC has been adopted for certain employee award and grant schemes.

Japan

In the Japanese context, a unit trust structure can often offer tax and other benefits to many Japanese investors when compared with a limited partnership vehicle. It is possible to structure the unit trust to incorporate the characteristics of a traditional private equity fund, including commitment and capital call features, claw-backs and defaulting investor provisions.

Private equity has proved popular with Japanese banks, pension funds, life insurers and other institutional investors seeking to rebalance their portfolios into private equity in the search for higher yields over a number of years, including foreign private equity. This is despite a continued weakening of the Yen against the US dollar in recent years, which has put pressure on Japanese investors to fund US dollar-denominated commitments and, in some cases, has led to reduced commitment sizes or increased selectivity on funds targeted.

Global structures

A number of managers will utilise a mix of parallel fund vehicles to maximise the global distribution of their funds and manage downstream assets. By way of example, managers targeting investors in multiple regions, including Europe, may look to offer parallel Cayman Islands, Delaware and Luxembourg fund options, or a variation on that arrangement such as a master-feeder fund structure with a Cayman Islands closed-end fund vehicle operating as a feeder fund into a European (such as an Irish or Luxembourg) master fund. Similarly, a Cayman Islands closed-end fund vehicle may set up holding or trading vehicles in various European jurisdictions (such as Ireland or Luxembourg) to facilitate its investment objectives.

Regulatory

A sophisticated legislative and regulatory framework has enabled the Cayman Islands to respond to the challenges and opportunities arising out of evolving, and often conflicting, regulatory developments. Several key regulatory developments in recent years are outlined below.

The private funds regime

The Private Funds Act (As Revised) came into force in 2020 and provides a regime for the regulation of closed-end funds (private funds) by CIMA. The new regime introduced a proportionate regulatory overlay for private funds with several benefits, was responsive to recommendations by international partners and reflects the Cayman Islands' commitment as a co-operative jurisdiction, as affirmed by various international organisations. It covers similar ground to existing or proposed legislation in a number of other jurisdictions.

Furthermore, in April 2023 CIMA released a series of updated and new regulatory measures

for regulated entities (including private funds), which included the Statement of Guidance on Corporate Governance for Mutual Funds and Private Funds, the purpose of which is to provide guidance on the minimum expectations for the sound and prudent governance of regulated funds. It sets out the key corporate governance principles pertaining to the operators of regulated funds as a guide to CIMA's expectations with regard to governance. CIMA also issued the (i) Rule and Statement of Guidance – Internal Controls for Regulated Entities, which requires regulated entities (including private funds) to establish, document and maintain an adequate and effective system of internal control; and (ii) The Rule – Corporate Governance for Regulated Entities, which requires regulated entities (including private funds) to establish, implement and maintain a corporate governance framework commensurate with their size, complexity, nature of business, structure, risk profile and operations.

Automatic exchange of information (AEOI)

The Cayman Islands has implemented the comprehensive AEOI regimes of both the Organisation for Economic Co-operation and Development's (OECD) Common Reporting Standard (CRS) and the US Foreign Account Tax Compliance Act (FATCA). Reporting financial institutions have customer due diligence and annual reporting obligations in the Cayman Islands, and an annual requirement to file a CRS Compliance Form. Reports, as well as the annual CRS Compliance Form, are filed with the Cayman Islands Tax Information Authority (TIA) administered by the government's Department for International Tax Cooperation. The TIA, in turn, provides account information automatically to the tax authorities of over 100 jurisdictions.

Tax Information Authority (International Tax Compliance) (Country-by-Country Reporting) Regulations, 2017

The Cayman Islands introduced the Tax Information Authority (International Tax Compliance) (Country-by-Country Reporting) Regulations in 2017. These regulations implement in the jurisdiction the model legislation published under the OECD's Base Erosion and Profit Shifting Action 13 Report (Transfer Pricing Documentation and Country-By-Country Reporting).

Anti-money laundering (AML) regulations

The Cayman Islands continues to review and revise its AML regulations and related guidance from time to time, to ensure they remain in line with current Financial Action Task Force (FATF) recommendations and global practice. The requirements of the AML regulations include the appointment of natural persons as AML officers to entities carrying on "relevant financial business" (which includes Cayman Islands investment funds vehicles) to oversee the effective implementation of AML programmes carried out by or on behalf of such entities. As a result of the Cayman Islands' continued enhancement of its AML/CFT regime, including by way of introducing administrative penalties and sanctions that are intended to be effective, proportionate and dissuasive, the FATF has determined that the Cayman Islands has the highest compliance rating with respect to all 40 FATF recommendations relating to AML and countering the financing of terrorism, and that it has satisfied all of the FATF's recommended actions for the jurisdiction, recognising that the Cayman Islands has a robust and effective AML and counter-terrorist financing regime.

Beneficial ownership and transparency

The Beneficial Ownership and Transparency Act (As Revised) (BOTA), the Cayman Islands' new

beneficial ownership regime, was brought into force on 31 July 2024.

BOTA modifies the beneficial ownership regime that had been in place in the Cayman Islands since 2017 in a manner that aligns with equivalent regimes in other jurisdictions, such as the US Corporate Transparency Act. BOTA extends the reach of the beneficial ownership regime to most Cayman Islands entities and removes most of the exemptions previously relied upon.

The new regime applies to all "legal persons", which includes companies, LLCs, LLPs, limited partnerships, ELPs, foundation companies and certain other legal persons prescribed in regulations, with such persons being required to complete and maintain a beneficial ownership register at their Cayman Islands registered office with a licensed corporate service provider. Cayman Islands trusts and non-Cayman Islands vehicles, including foreign entities that are registered in the Cayman Islands, are out of scope of BOTA.

The regime also provides certain legal persons with an alternative route to compliance (meaning the legal person would not be required to report their beneficial owners or establish a beneficial ownership register, but rather report limited "required particulars"). This route is available to a legal person who is: (i) listed on the Cayman Islands Stock Exchange (CSX) or an approved stock exchange (including subsidiaries of a listed entity) or (ii) licensed under certain Cayman Islands regulatory laws.

Additionally, an investment fund registered with the CIMA under the Private Funds Act (As Revised) or the Mutual Funds Act (As Revised) may choose to comply with BOTA by either satisfying obligations under the default regime (as highlighted above) or availing itself of an investment fund-specific alternative route to compliance.

A registered investment fund that elects to pursue the alternative option will not be required to maintain a register of its beneficial owners. Instead, Cayman Islands-domiciled investment funds registered with CIMA as mutual or private funds that rely upon the alternative route to compliance will be required to supply the contact details of certain Cayman Islands service providers, such as its registered office services provider or a licensed fund administrator. That contact person will be required to provide beneficial ownership information, on behalf of the registered investment fund, to the competent authority on request within 24 hours (or such longer period as may be specified in the competent authority's request).

The regime provides that the Cayman Islands government may make further regulations in due course, empowering the Cayman Islands registrar to provide public access to certain required particulars of registrable persons (such as persons who meet a "legitimate interest test"), which may include access to organisations that have a genuine role in preventing or combating money laundering and terrorist financing.

The International Tax Co-Operation (Economic Substance) Act

In further response to and compliance with OECD base erosion and profit-shifting standards, in December 2018, the Cayman Islands brought the International Tax Co-Operation (Economic Substance) Act (As Revised) and associated regulations and guidance into force. This law introduced reporting and economic substance requirements for certain Cayman Islands-domiciled entities and partnerships undertaking certain activities, with reporting made to the TIA.

The economic substance regime incorporates certain exemptions specifically for vehicles that fall within the statutory definition of an investment fund.

Data protection

The Data Protection Act (As Revised) (DPA) came into force in late 2019. This law imposes certain obligations on Cayman Islands vehicles that handle personal information relating to an individual with respect to that information. The DPA data protection principles are equivalent to those in force under other comparative legislation, such as General Data Protection Regulation in Europe.

Continuing dialogue

The Cayman Islands continues to have dialogue with a number of international partners and governing regulatory bodies, including the OECD and the FATF, to ensure that the jurisdiction maintains a robust and proportionate regulatory framework that is implemented in an effective manner to meet internationally accepted best practice standards.

Impact on offering and subscription documents

At the establishment stage, these regulatory matters are being reflected in more detailed disclosures in offering and subscription documents. By way of example, investors are being required to make disclosures that pertain to AML and tax transparency considerations, and sponsors are addressing data protection and sanctions obligations together with economic considerations, such as those pertaining to the costs that will be allocated to the fund as fund expenses as opposed to the costs incurred by the manager.

These are dynamic and ongoing obligations, the nature of which is reflected in fund documents and Cayman Islands notification and reporting obligations of the nature described above.

Fair disclosure and compliance

There is also an emphasis on fair disclosure. During a fund's life cycle, as in key onshore jurisdictions, sponsors engage in ongoing dialogue with investors and advisory boards to ensure that key matters, notably conflicts, are fairly disclosed, including in the context of fees (which has been an area subject to well-publicised onshore regulatory enforcement actions).

The scope for conflicts can be particularly acute at the end of a fund's life, for example where liquidity is sought, or value optimised, by way of a continuation fund, a general partner-led secondary transaction or a term extension. In those instances, a sponsor may receive new material information in the midst of an all-partner consent process, or prior to a deal being consummated, which the sponsor (and/or general partner) must disclose so that investors are able to make an informed decision with reference to those revised particulars.

Given that the regulatory framework is evolving quickly and becoming more complex and multilayered, an increasing number of sponsors look to outsource compliance functions, such as AML/KYC verification and tax transparency reporting obligations, to third-party specialists. This allows management companies to dedicate more resources to their core investment-focused activities, and to more clearly delineate between fund and house expenses.

Geographic Factors Impacting Cayman Islands Private Equity Trends

The Cayman Islands product has broad global appeal, although several trends are dictated by geographic factors.

Fundraising

Following the soft North American fundraising market of 2023 resulting from the difficult economic and political environment, private equity fundraising looks to have slightly rebounded in the first half of 2024. While fund sizes are still slightly smaller than those seen in 2022, fundraising timelines have significantly accelerated. In light of this renewed growth, there continues to be consistent demand for the establishment of Cayman Islands structures, with a range of vehicles including small bespoke sidecar funds, mega-funds and downstream structuring vehicles. The broad flexibility of the Cayman Islands' offering ensures there is wide appeal among mid-market and start-up managers, as well as allocators and investors, in establishing Cayman Islands vehicles intended to fulfil a wide range of purposes.

The European private equity market has been impacted in recent years by global market uncertainty, inflation, the conflict in Ukraine and, latterly, the Israel-Gaza war. Fundraising in Europe held up relatively well amongst the larger buyout firms; however, it remained a challenging environment for deal-making.

The Cayman Islands continues to be a popular jurisdiction for UK managers looking to establish offshore private equity funds, especially where there is a transatlantic nexus.Increased fund oversight and investor protection through the implementation of the Private Funds Act and the strengthening of CIMA's regulatory powers have, together with certain other recent legal and regulatory developments, in particular with regards to corporate governance and internal controls rules, served to more closely align Cayman Islands private funds with the regulated framework that European private equity fund managers and investors are used to operating in under the Alternative Investment Fund Managers Directive.

Owing to pandemic disruptions, geopolitical uncertainties and regulatory clampdowns, fundraising in the region proved difficult throughout 2022 and continuing into 2023. Despite the rise of "onshore" fund jurisdictions in Asia, Cayman Islands entities continue to remain the vehicles of choice, particularly for large global managers.

Global landscape

A number of potential headwinds continue in Asia-Pacific as we move into late 2024: global investors remain concerned about China's economic growth and increasing investment risk given rising geopolitical tensions and tighter industry regulation. Political and economic uncertainty casts a shadow over the region's exit market, and the closing of the US IPO exit route for many Chinese companies has significantly reduced the number of Chinese firms listing in the US. Additionally, global macro factors, including the war in Ukraine, high inflation, still-high interest rates and US political uncertainty, may be negatively impacting investor sentiment.

The Cayman Islands continues to be the dominant jurisdiction of choice for sponsors and investors alike in the Asia region, being favoured for investment funds launched across different disciplines ranging from traditional private equity to real estate and credit funds. In the Southeast Asian market, there has been an increase in the number of structures using both Cayman and Singapore vehicles; for instance, a Cayman feeder partnership into a Singapore variable capital company (VCC) master fund has been popular in the VC fundraising space.

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Continued growth

As noted above, there is a continued interest from Japanese institutional investors in private equity, with many Japanese investors continuing to diversify by allocating funds to the asset class or increasing allocations. Tech investments continue to be a major focus in South-East Asia. With many valuations coming down, this may lead to increasing deal flow, although this may be tempered by a "risk-off" approach being adopted by investors given global macro factors.

Looking Ahead

If the financial markets continue to recover from the significant macroeconomic disturbances seen in recent years, private equity is well situated to capitalise on the emergence from the prolonged market uncertainty through an innovative and robust approach to investment strategies and value growth.

Against this backdrop, the Cayman Islands remains well placed to maintain its position as the principal offshore jurisdiction for private equity given the flexible structuring options, investor familiarity with Cayman Islands structures and proportionate regulatory framework that continues to adapt in a robust and responsive manner to the needs and expectations of sponsors, investors and international partners.

CHINA

Law and Practice

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JunHe was founded in Beijing in 1989 and was one of the first private partnership law firms in China. JunHe has grown to be a large and recognised law firm with 14 offices around the world and a team comprised of more than 1,000 professionals. It is committed to providing top-tier legal services in commercial transactions and litigation. JunHe is well known for being a pioneer, an innovator and a leader in the re-establishment and development of the modern legal profession in China. JunHe's attorneys are organised into multidisciplinary practice groups to ensure that they are equipped with deep expertise in market-tailored legal fields and industry sectors. To meet the specific requirements of each client and project, project teams are formed across different practice groups in JunHe, leveraging the strengths of the lawyers and ensuring the requisite skills are available to offer bespoke legal advice. By consistently providing exceptional representation, JunHe has earned its reputation for excellence.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

China's private equity (PE) and M&A market has been gradually recovering from the COVID-19 pandemic, but it is still faced with challenges in 2024 due to the global macroeconomic slowdown.

It is no secret that the PE and M&A market experienced a significant downturn in 2023, reportedly reaching the lowest point in a decade according to various market research agencies. The Chinese M&A market saw a decline of approximately 20–30% in 2023, with cross-border transactions experiencing a particularly drastic drop.

According to PwC, in 2023, the total transaction value of M&A deals in China was USD333.1 billion, which represents a 28% decrease compared with that in 2022. Similarly, Deloitte found that, in 2023, a total of 8,821 M&A deals were announced in the Chinese market, a year-on-year decrease of 5.18%. The transaction value was approximately CNY1.899 trillion, down by about 22.86% compared with 2022.

Despite a general decline in the Chinese market in 2023, transactions in certain sectors and industries remained active. For example, investments by state-controlled enterprises in 2023 increased by 6.4% according to Deloitte; investments in information, energy, high-tech and other industries were all increasing. Furthermore, Chinese enterprises' outbound investments increased drastically.

In the first half of 2024, investors remained cautious. It was reported that, in total, there were 3,674 Chinese M&A deals, representing a decrease of 3.32% compared with 2023. The transaction value was approximately CNY709.9 billion, down by about 12.45% from 2023.

1.2 Market Activity and Impact of Macro-Economic Factors

The Chinese market in 2024 is poised to see increased activity in several key areas, including internal consolidation among enterprises, robust overseas investments by Chinese companies, potential market exits by foreign-invested enterprises and heightened M&A activity by state-owned enterprises.

First, the overall recovery of the Chinese market in 2024 is likely to be relatively slow. The economic downturn is expected to prompt some smaller or less profitable enterprises to consider selling at reasonable prices to industry leaders or more capable and ambitious companies. Consequently, horizontal consolidation within industries will remain a significant trend in the Chinese market in 2024. In the first half of 2024, horizontal consolidation deals accounted for 22.22% of all M&A deals in China.

Second, Chinese enterprises are actively pursuing overseas investments. This trend may result in an increase in cross-border M&A as Chinese companies expedite their global expansion and enhance their international presence.

Additionally, factors such as geopolitical tensions and uncertainties in China-US relations may prompt foreign-invested enterprises in China to consider exiting the Chinese market; this could lead to an increase in such transactions.

Moreover, since the State-owned Assets Supervision and Administration Commission convened a special meeting in June 2023 to enhance the quality of listed companies and promote M&A

activities, state-owned enterprises have become more active in the capital market. State-owned enterprises are expected to further engage in M&A within their traditional sectors and strategic emerging industries in 2024, with the aim of optimising the structure of state-owned capital.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Improved Regulatory Framework for PE Funds

In 2023, a series of regulatory policies were issued in the PE fund sector, leading to a reshaping of the regulatory framework for PE funds. The most significant development was the enactment of the Private Investment Fund Supervision and Administration Regulation in September 2023, which is the first administrative regulation in the private investment fund sector and also promotes healthy and regulated development of the PE fund industry within a legal framework.

Following the Private Investment Fund Supervision and Administration Regulation, certain related policies and supporting rules have been introduced, resulting in noticeable changes in this industry. On the one hand, non-compliant PE funds have been swiftly purged, with over 900 PE firms being deregistered and hundreds being penalised for violations in 2024. On the other hand, leading PE firms are actively enhancing their research and investment capabilities following the latest regulatory requirements.

With the Increased Difficulty of IPO Exits, a Trend Towards M&A Exits Has Emerged

Since 2023, China's A-share IPO requirements have become increasingly stringent, and the path to overseas listings is also being affected by tighter regulation, forcing many companies to terminate their listing plans. Statistics indicate that, out of the 313 companies that successfully completed IPOs on the A-share market in 2023, 237 involved PE fund investments, representing a penetration rate of 75.7%. However, in terms of investment returns for PE funds, the average multiple of investment returns as of the IPO date was 4.8 in 2023, down 10% from 5.37 in the previous year. Due to these constraints, many PE funds are now exploring M&A exits as a new plan.

New Company Law Implemented

The new Company Law of the PRC came into effect on 1 July 2024. This revision is the most extensive since the law was first enacted in 1993, involving reforms in the company capital system, the refinement of shareholder rights, and adjustments to corporate governance structures, etc. These changes are expected to impact various aspects of PE fund activities, including fundraising, investment, management, and exit strategies.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Formation and Operation of PE Funds

PE funds are investment vehicles established to raise capital from investors in a non-public manner. These funds are managed by fund managers for the purpose of investment activities. In China, PE funds can be structured as a company, a limited partnership or mere contractual arrangements.

The China Securities Regulatory Commission (CSRC) is the primary regulatory authority overseeing securities and capital markets.

The Asset Management Association of China (AMAC) serves as a self-regulatory organisation that supervises and regulates the activities of PE fund managers and other asset management institutions in China.

PE fund managers are required to register with the AMAC and complete the necessary filing procedures after successfully raising private capital. The formation, governance structure, fundraising, investment activities, reporting obligations, information disclosure, liquidation, and distribution of PE funds are subject to various rules and regulations issued by the CSRC and AMAC. Furthermore, foreign investors participating in PE funds formed in China must also comply with foreign investment regulations and foreign exchange control requirements in China.

Restrictions on Foreign Investments

The Law of the People's Republic of China on Foreign Investment provides national treatment to foreign investors, except for investments made in any industry listed on the negative list. In general, foreign investment controls no longer apply to foreign financial sponsors if the investment is not made in a negative-listed industry. However, national security reviews may still be required for investments that might have an impact on national welfare. Additionally, China has its own foreign exchange control regime, subjecting the inflow or outflow of funds to government clearance.

For sectors on the negative list, foreign PE funds may still invest in restricted sectors if certain requirements are met (eg, co-operation with a Chinese partner and the Chinese partner maintaining controlling ownership), and with prior approval from the relevant regulatory authorities. However, foreign investors are prohibited from directly or indirectly holding equity interests in companies engaged in prohibited sectors.

To invest in restricted or prohibited sectors, some foreign investors utilise a variable interest entity (VIE) structure instead of direct or indirect stock ownership. However, the Chinese government has posed increasing challenges to this VIE structure in recent years. In 2023, the CSRC proposed a new filing-based regulatory regime for overseas listings of companies with VIE structures, introducing more uncertainties for companies employing such a structure.

Antitrust Review

The State Administration for Market Regulation (SAMR) is the regulatory authority responsible for antitrust review in China. Under law, a transaction will be subject to Chinese antitrust clearance if it results in a change of control of the target company and meets the following PRC antitrust filing thresholds:

- if two or more participants each generate a turnover exceeding CNY800 million in China in the last fiscal year; and
- if the total turnover generated by all participants in China in the last fiscal year exceeds CNY4 billion or if the total worldwide turnover exceeds CNY12 billion.

In transactions triggering antitrust review, the parties involved are required to make a prior declaration to the SAMR, and the transaction should not proceed until antitrust clearance is obtained. It is important to note that, under PRC merger filing rules, minority investments by multiple financial sponsors in the same target may be considered as joint control if these sponsors possess significant veto rights over operational matters. Consequently, some financial sponsors deliberately refrain from acquiring veto rights at

the board or shareholder level to avoid triggering the need for merger clearance when making minority investments in a target.

National Security Review

The Working Mechanism Office for the Security Review of Foreign Investment (an agency established within the National Development and Reform Commission) is the regulatory authority responsible for national security review in China. Foreign investments falling within the following scope are subject to national security review:

- investments in the military related industries; and
- investments in control over other critical sectors related to national security, including significant agricultural products, energy and resources, equipment manufacturing, infrastructure, transportation services, cultural products and services, information technology and internet products and services, financial services and key technologies.

Currently, the Chinese government does not provide a clear list of specific types of projects that are subject to the national security review. In practice, foreign investors or relevant domestic parties usually engage professional legal advisors to review the project before implementing the transaction. If there are factors that may give rise to a national security concern, they may take the initiative to report to the authority for advice on whether a national security review is required.

ESG

In recent years, a significant amount of funds have flowed into ESG-related services and investment products, leading to a substantial increase in the number of PE funds oriented towards ESG investment. AMAC has actively encouraged the establishment and implementation of ESG-related investment funds. It has issued the Recommendations on the Green Investment Self-Assessment Report Framework for Fund Managers and the Green Investment Self-Assessment Form for Fund Managers. PE fund managers are required to conduct an annual self-assessment of their green investment practices and submit the report and form to the AMAC.

In September 2023, Beijing introduced the first industry-wide standard for ESG-related investment funds, known as the Guidelines for Sustainable Investment Information Disclosure by Private Equity Fund Managers (the “Guidelines”). The Guidelines encourage PE fund managers registered and established in China to publish at least one annual sustainable investment report to the public.

4. Due Diligence

4.1 General Information

Normally, PE investors will engage external legal counsel to conduct comprehensive legal due diligence when dealing with Chinese target companies. The key areas of focus in the legal due diligence process typically include corporate structure and governance, licences, regulatory compliance, material contracts, real estate and property, intellectual property rights, management and employee matters, financial and tax matters, insurance, environment, health and safety matters, administrative penalties, litigation and disputes.

The legal due diligence process in China is typically conducted through a combination of public information searches, legal document reviews, management interviews, site visits and discussions with relevant stakeholders. The outcome

of the legal due diligence review for PE transactions is usually the issuance of a red-flag report that summarises key concerns and proposed mitigations. Compared with strategic investors, PE investors are more concerned about issues that may impact the valuation of the target company and their exit strategy, such as non-compliance issues that could hinder the target's IPO.

4.2 Vendor Due Diligence

Vendor due diligence is less common for PE transactions in China, as buyers usually prefer to conduct their own legal due diligence through their own legal counsels. However, in auction sales, sell-side legal advisers in China will sometimes provide reports or fact books that summarise the findings of the vendor due diligence for the purpose of costs control and transaction efficiency. These reports cover various legal aspects of the target company, including corporate structure, regulatory compliance, contracts, litigation, intellectual property and other relevant areas. The content and format of these reports may vary depending on the specific transaction and the preferences of the seller and their advisers.

Normally, sell-side advisers will only provide very limited reliance on the vendor due diligence reports to potential buyers. They may issue letters stating that the reports were prepared based on information provided by the seller, and that the buyer can rely on them to a certain extent. However, it is still recommended for buyers to conduct their own due diligence to verify the accuracy and completeness of the information provided in the vendor due diligence reports, as reliance is often limited in nature.

5. Structure of Transactions

5.1 Structure of the Acquisition

In China, most acquisitions by PE funds are carried out through private sale and purchase agreements. The auction approach is less commonly employed. If state-owned assets are involved, the transaction generally should go through an open bidding procedure with relevant exchanges. For listed companies, deals are typically concluded through methods like private placements, block trading and tender offers.

In a privately negotiated transaction, the parties typically begin by negotiating and signing a term sheet that outlines key commercial and legal terms, although most terms in the term sheet are not legally binding. This is followed by due diligence and the preparation and negotiation of transaction documents. The term sheet can be renegotiated or supplemented according to the findings of due diligence and the negotiations between relevant parties. In contrast, in an auction sale, sellers are normally in a more advantageous position to set transaction terms, while buyers tend to have less bargaining power and may focus more on key terms, especially in judicial auctions. For listed companies, transaction structure and terms are subject to applicable securities rules and disclosure requirements and therefore tend to be less flexible.

5.2 Structure of the Buyer

The PE-backed buyer is typically structured as a limited liability partnership that usually has one general partner (GP) and several limited partners (LPs). The GP manages the partnership and assumes unlimited liability, while the LPs assume limited liability within the scope of their respective capital contribution. The specific transaction structure of a deal is subject to various factors, including tax considerations, legal

requirements, confidentiality concerns and the nature of the target company. PE funds often establish multiple layers of special purpose vehicles overseas for involvement in acquisition documentation and are less likely to become a direct contracting party of transaction documents. The multilayered structure helps mitigate risk, optimise tax efficiency and maintain confidentiality, thus ensuring better protection and flexibility in managing the PE funds' investments.

5.3 Funding Structure of Private Equity Transactions

In China, PE buyers typically rely on the capital they have raised for their investments. The use of debt financing, such as bank loans, is not prevalent in the Chinese market for PE transactions. This is partly due to the stringent legal system for financing and foreign exchange in China. When it comes to transactions involving offshore levels, the dynamics change. Specifically, if the target company is an offshore holding company of a Chinese enterprise, a combination of equity and debt financing becomes more common. In such cases, the PE buyer may leverage offshore financing sources to structure a deal that combines both equity and debt.

5.4 Multiple Investors

Consortium deals are common in Chinese PE transactions, especially when the target is of high quality or high value with promising prospects. Co-investment by other external investors alongside the lead PE fund or GP is also common in China. LPs often actively seek co-investment rights with the GP of the fund. Based on the specific deal, consortia may include both PE funds and corporate investors.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Fixed price, completion accounts and a performance-based valuation adjustment mechanism (VAM) are the predominant forms of consideration structures used in PE transactions in China. It is also not uncommon for the transaction parties to adopt more flexible consideration mechanisms, such as earn-outs, deferred payment and roll-over structures, when there are uncertainties regarding the post-closing performance of the target company. These mechanisms provide flexibility in addressing potential risks and aligning the interests of the parties involved.

In general, PE fund sellers usually prefer consideration structures that provide upfront cash proceeds, such as fixed-price with or without locked-box, while PE fund buyers may consider earn-outs, deferred consideration or a performance-based VAM to reduce future uncertainties and incentivise future performance management.

PE funds usually have more experience and resources to negotiate and enforce the terms of the consideration mechanism. They may also have more sophisticated mechanisms for protecting their interests, such as indemnification provisions or escrow arrangements. Corporate sellers or buyers may have different risk appetites, and compared with PE buyers, corporate buyers tend to be more inclined to offer higher prices and a more favourable consideration to sellers. This is often due to the potential strategic advantages and synergies they see in acquiring the target company.

6.2 Locked-Box Consideration Structures

The fixed-price locked-box consideration structure is not commonly used in PE transactions when dealing with Chinese target companies. In fixed-price locked-box consideration structures, the equity price is agreed upon and fixed at the time of the transaction, and interest is typically not charged on the equity price. Besides, it is not typical to charge (reverse) interest on the leakage during the locked-box period.

6.3 Dispute Resolution for Consideration Structures

In transactions structured with a completion accounts mechanism, it is common to include a dispute-resolution mechanism to address any disagreement regarding the closing account adjustment items, and the parties often appoint an independent expert, such as an accounting firm or a valuation specialist, to review and resolve disagreements related to the adjustments made to the purchase price based on the completion accounts. It is also important to include provisions regarding:

- the method for selecting such an auditor;
- a specified timeframe to resolve any disputes;
- the scope of items and amounts that can be considered in resolving the dispute; and
- the allocation of fees and expenses between the parties.

As for transactions structured with other consideration mechanisms, such as fixed-price, earn-outs, or a performance-based VAM, the parties typically rely on the general dispute resolution provisions outlined in the transaction documentation to resolve any disputes that may arise.

6.4 Conditionality in Acquisition Documentation

The level of conditionality in PE transactions in China can vary depending on the specific deal and parties involved. In general, PE transactions in China typically include substantive closing conditions such as:

- corporate authorisations to execute the transaction documents;
- receipt of internal and external approvals or consents;
- completion of certain governmental registrations or filings;
- continued accuracy of representations and warranties from signing to closing;
- no material adverse changes between signing and closing; and
- other conditions related to key legal due diligence findings, such as the completion of corporate restricting and the rectification of certain non-compliance issues; financing of the closing funds is typically not considered a closing condition in China.

The requirement for third-party consent as a closing condition is primarily determined by the target company's contractual obligations and the potential material adverse impact on the company if such consent is not obtained. This is particularly relevant when there are important contracts that may impact the success of the transaction. For example, the commercial banks or key customers of the target company may demand prior consent if there is a change of control in the company. Failure to obtain these consents could lead to the imposition of accelerated loan repayment plans by banks, early termination of contracts by customers or cancellation of the target company's vendor qualifications. In such cases, obtaining third-party consents will be considered as a closing condition.

6.5 "Hell or High Water" Undertakings

"Hell or high water" undertakings are not commonly seen in PE transactions in China, particularly in cases where the regulatory approvals (such as antitrust clearance, national security review and approvals in relation to restricted foreign investment areas) are significant conditions to complete the deal. The parties are required to make reasonable best efforts to fulfil the regulatory condition as promptly as practicable. If the regulatory condition cannot be fulfilled prior to the agreed long-stop date, it is common for the non-breaching party to have the right to terminate the agreement without any break fee.

6.6 Break Fees

While break fees are not unheard of in China, they are not as prevalent in the market. In limited situations where break fees do apply, the typical triggers for such fees may include instances where the seller fails to fulfil its obligations or breaches the terms of the agreement, leading to termination of the deal. In China, there is no legal restriction on break fees, allowing parties to negotiate and agree upon the amount. However, it is important to consider the enforceability of break fees under PRC Civil Code and potential challenges in court if the amount is deemed excessive or a penalty rather than a genuine pre-estimate of damages. Courts in China tend to scrutinise the reasonableness of liquidated damages, including break fees, and may adjust or limit their enforcement if found to be excessive or unconscionable. In this regard, the volume of break fees, if applicable, is often limited to 130% of the actual losses incurred by a non-breaching party arising from the termination of the transaction.

Reverse break fees, where the buyer pays a fee to the seller in the event of a deal's termination, are also uncommon in China. However, it is possible for parties to negotiate and include reverse break fees if they deem it appropriate and mutually beneficial to allocate the risk of deal failure.

6.7 Termination Rights in Acquisition Documentation

In PE transactions in China, the acquisition agreement can be terminated either through mutual agreement or through the exercise of a unilateral termination right based on specific agreed-upon circumstances. These circumstances may include:

- failure to fulfil closing conditions before the long-stop date;
- breach of representations and warranties;
- discovery of undisclosed material negative matters;
- occurrence of material adverse effect; and
- insolvency, liquidation or dissolution of a party.

The longstop date is typically negotiated between the parties and depends on various factors, including the complexity of the deal, regulatory requirements and other relevant considerations. It is commonly set between three to six months in PE transactions in China but can extend up to six months to one year in more complex transactions.

6.8 Allocation of Risk

PE-backed transactions often involve higher-level risk mitigation measures due to the nature of the investment and the shorter-term ownership horizon of PE funds. It is common for PE buyers requiring sellers to provide a comprehensive list of representations and warranties and detailed disclosures in the transaction documents, and the sellers are required to compensate the buyer for false representations and warranties. Furthermore, PE investors often employ various strate-

gies to mitigate investment risks, including price adjustment mechanisms, deferred payments, escrow arrangements and the implementation of preferential and flexible exit mechanisms in the transaction documents. Such exit mechanisms may include tag-along rights, drag-along rights, put options, and liquidation preference rights. In exit transactions, PE sellers generally aim for clean exits by minimising the scope and survival periods of their warranties and imposing caps on indemnity liabilities to the greatest extent possible.

On the other hand, in transactions where the seller or buyer is a strategic investor, there may be a greater level of reliance on the buyer's own due diligence and business judgement as the strategic investor usually has a deeper understanding of the industry and the specific business being acquired. However, in general, strategic investors share similar risk allocation strategies as PE investors, such as utilising price adjustments, representations and warranties, indemnification, and termination provisions.

6.9 Warranty and Indemnity Protection

To achieve a clean exit, a PE seller would typically limit the scope of warranties and subsequent indemnifications, especially when the seller only holds a minority stake in a target company (which is often the case in China). It is common for PE sellers to provide only fundamental warranties related to the ownership and title of the shares being sold, in the absence of encumbrances and due authorisation to complete the transaction. Operational warranties and warranties concerning the financial and material assets of the target company are less likely to be accepted by a PE seller who is a minority shareholder.

However, if a PE seller is a majority shareholder, its warranties would generally be more comprehensive and may extend to knowledge of the target company's management, as they are usually responsible for its operation. It is rare for the target company's management to issue warranties directly to the buyer, as they are typically not party to the transaction.

In PE transactions in China, the buyer usually does not accept the seller's general reference to the data room and will require the seller to accurately disclose the specific exceptions to the representations and warranties through a disclosure letter. This practice ensures that any specific matters or information disclosed in the data room are expressly accounted for and do not serve as exceptions to the warranties. Whether the buyer is PE-backed or not does not typically impact the warranties provided by a PE seller.

The customary limits on liability for a seller's warranties and indemnities can also vary but may include provisions such as caps on liability, de minimis thresholds (minimum claim amount), baskets (thresholds that must be exceeded before claims can be made), deductibles (amounts the buyer must bear before the seller becomes liable) and survival periods (periods during which claims can be made). The specific limitations will depend on the terms negotiated between the parties and the particular circumstances of the transaction.

6.10 Other Protections in Acquisition Documentation

In PE transactions in China, the buyer usually requests that the seller eliminate the key issues with high-risk exposure before closing. Alternatively, the buyer may seek a reduction in the purchase price to account for such risks. Instalment payments, an escrow or retention arrangement, post-closing adjustments and indemnification

provisions are commonly used to increase the enforceability of the seller's indemnifications. The escrow or retention amount may be used to satisfy claims for breaches of fundamental warranties, business warranties, and tax or other indemnities.

Warranty and indemnity (W&I) insurance is not commonly seen in PE transactions in China, but in certain cross-border transactions, foreign PE investors may consider purchasing W&I insurance as a means to mitigate potential risk exposure. The coverage of the insurance can extend to both fundamental warranties and business warranties, and in some cases may also include tax-related matters. The specific coverage and terms of the W&I insurance policy would be subject to negotiation between the parties and the insurance provider.

6.11 Commonly Litigated Provisions

Litigation in connection with PE transactions is not commonly seen in China. The parties often opt for domestic or international arbitration as the preferred method for resolving disputes, as arbitration is generally considered to be more flexible and equitable, with greater confidentiality in China. The selection of arbitration institutions in Beijing, Shanghai, Hong Kong and Singapore is more common in PE transactions in China.

In terms of the most commonly disputed provisions in PE transactions, they typically involve representations and warranties, indemnities, earn-outs, valuation adjustments, redemptions, put options, and shareholder or parent guarantees. These provisions often give rise to disagreements and potential disputes between the parties.

7. Takeovers

7.1 Public-to-Private

In China, the delisting of public companies can be categorised into two types: forced delisting and voluntary delisting. Forced delisting occurs when the listed company fails to meet the regulatory or listing requirements, leading to its mandatory removal from the exchange. This could be due, for example, to financial instability or a major violation of law. On the other hand, in the case of voluntary delisting, a company decides to delist itself from the stock exchange. In practice, voluntary delisting of Chinese companies is quite rare. However, Chinese companies listed overseas are more frequently engaged in public-to-privates transactions.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

In China, when an investor holds 5% or more of a listed company's shares after a proposed transaction, it must prepare and submit a report on the change of shareholding to the CSRC and the stock exchange within three days, notify the listed company and make a public announcement. The investor is generally not allowed to trade the shares until after the public announcement.

The investor must follow similar reporting and disclosure obligations post-initial transaction every time it acquires or disposes of 5% or more of the shares of the listed company on an accumulative basis. In addition to these disclosure obligations, the investor should generally suspend trading of the listed company's shares for a certain period, typically until three business days have elapsed after the public announcement date.

If the investor fails to comply with the above-described reporting and disclosure obligations and acquires 5% or more of the shares of the listed company, the investor is not permitted to exercise its voting rights in relation to the newly acquired shares for 36 months.

Furthermore, an investor holding 5% or more of a listed company's shares is required to notify the listed company and make a public announcement every time its shareholding ratio increases or decreases by 1% or more on an accumulative basis.

7.3 Mandatory Offer Thresholds

In China, 30% is the mandatory offer threshold. If an investor obtains more than 30% of a listed company's shares, whether through an agreement transfer, voting rights agreement or other arrangements, indirect acquisition or secondary market transactions, the investor must make a tender offer to all other shareholders to acquire all of the remaining shares of the company unless an exemption applies. If the investor holds 30% of a listed company's shares and wishes to acquire more shares, it must make a tender offer to all other shareholders to acquire all or part of the remaining shares of the company.

There are certain exemptions on the mandatory tender offer, such as proposed share transfer between entities controlled by the same final beneficiary, or where the purpose of the transaction is to save the listed company from severe financial difficulties and the investor undertakes to not dispose of its shares within three years.

7.4 Consideration

Cash is more commonly used in China as consideration. PRC law generally does not restrict non-cash payment, but compared with cash, it appears to be less flexible with other forms of consideration. In a tender offer, the offer price for shares of the same category shall not be less than the highest price paid by the investor for such shares within a six-month period preceding the date of the indicative announcement on acquisition by offer. If the offer price is less than the mathematical average value of the daily weighted average prices for such shares over 30 trading days before the date of the indicative announcement, the financial consultant engaged by the investor shall analyse the trading of such shares within the latest six-month period and confirm whether the share prices are being manipulated, whether the investor has failed to disclose persons acting in concert with it, whether the investor has obtained the shares of the company by way of other payment arrangements during the past six months and the reasonableness of the offer price.

7.5 Conditions in Takeovers

Although the law does not restrict the use of offer conditions, most takeover offers only set customary regulatory conditions, such as obtaining certain regulatory approvals and necessary internal approvals, with few extra special conditions.

It is unusual for the bidder to obtain financing as a condition on a tender offer. Instead, the bidder is required to demonstrate its payment ability prior to the offer by way of a deposit, a letter of guarantee issued by a bank, etc.

In China, it is uncommon for a bidder to seek deal security measures such as break fees, match rights, force-the-vote provisions or non-solicitation provisions.

7.6 Acquiring Less Than 100%

If a bidder does not seek or obtain 100% ownership of a public company or permission to convert it into a private company, it normally cannot have extra governance rights except those in relation to its shareholding.

In China, it is quite rare for a bidder to obtain financing for payment of the consideration; therefore, there are no specific regulations regarding the setting of a particular threshold, and no specific mechanism for a debt push-down into the target after a successful offer.

The Company Law of the PRC (2023 Revision) introduced a new mechanism where, if a company merges with a subsidiary that holds not less than 90% equity or shares, the merger does not need approval at the subsidiary's shareholders' meeting, and the minority shareholders shall be served with a notice and shall have the right to request that the company acquire their equity or shares at a reasonable price. Said new mechanism is very similar to the squeeze-out mechanism in foreign countries, but it only occurs in the circumstance of a merger between the company and its subsidiary.

7.7 Irrevocable Commitments

Under PRC law, a shareholder can "pre-accept" a tender offer, which indicates its preliminary intent to agree to accept the offer and shall not constitute an irrevocable and binding undertaking until three trading days before the end of the acquisition period specified in the acquisition report prepared by the bidder. In other words, the pre-acceptance of the tender offer is not binding before this three-day period. However, once this period begins, the acceptance becomes binding and cannot be revoked by the shareholder, even if a better offer is made.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

In China, it is common to implement equity incentivisation for employees, typically including senior management and other key employees. These incentives are usually provided through employee stock-ownership plans, which may feature restricted shares and stock options. Shares allocated for these incentive programmes are often held by a nominee appointed by the company's founder through a limited partnership. In practice, before a company undergoes equity financing, the shares reserved for employee incentive plans generally range from 10% to 15% of the total shares, of which 50–70% are typically allocated to the management team.

8.2 Management Participation

Management participation in PE transactions is relatively uncommon in the Chinese market. When management does choose to participate, they generally need to purchase shares at the same price as the PE investor. Alternatively, they may exercise their rights under an existing employee stock-ownership plan. This ensures that management's investment is aligned with the PE investor's terms, maintaining fairness and consistency in the transaction.

8.3 Vesting/Leaver Provisions

Vesting and leaver provisions are key components when structuring equity incentives for management in PE transactions in China. These provisions are particularly relevant for shares or options obtained under employee stock-ownership plans.

Vesting provisions generally depend on negotiations between the PE investor and the management team. A typical vesting schedule for management options is four years, with 25% of

the shares vesting after the first year and the remainder vesting periodically over the following three years. Vesting conditions often include the achievement of certain performance goals.

Typically, the company or the controlling shareholder retains the right to acquire management shares if a manager's employment is terminated. Leaver provisions are often categorised into "good-leaver" and "bad-leaver" provisions. A good leaver might leave the company due to retirement, disability or death, while a bad leaver might leave under other circumstances. Under both good- and bad-leaver scenarios, any unexercised options or shares are usually cancelled. For exercised shares, a good leaver can either retain the shares until exit events or have them redeemed by the company at the exercise cost, fair market value or net asset value. In contrast, a bad leaver will have their shares redeemed at the fair market value or exercise cost (whichever is lower), with the company being entitled to deduct any damages caused by the bad leaver.

8.4 Restrictions on Manager Shareholders

The customary restrictive covenants for management shareholders typically include non-compete, confidentiality, non-solicitation, non-disparagement and full-time commitment clauses. These provisions ensure that management does not engage in competitive activities, disclose sensitive information, solicit company employees or clients, or make negative statements about the company. Additionally, key individuals in management are often required to maintain their positions at the target company for a specified period to ensure continuity and stability.

8.5 Minority Protection for Manager Shareholders

Typically, manager shareholders do not receive more protection than other minority shareholders. However, if a manager shareholder is crucial to the target company's operations and management, they might negotiate for board seats or veto rights over significant corporate decisions. While PE investors usually resist giving manager shareholders the power to control or limit their exit, these investors are often restricted from transferring shares to the target company's competitors.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

In China, PE investors are more commonly seen as minority shareholders of the target company. In such cases, PE investors usually do not directly participate in the daily operations of the company, but they will seek a series of minority shareholder protection rights in the transaction documents.

Board Appointment Rights

PE funds would usually require the right to appoint at least one representative to the board of directors of the portfolio company. The representative can provide oversight and help align the company's strategic direction with the fund's investment objectives. Normally, the director nomination rights will be allocated to shareholders pursuant to their respective equity ratios, but PE funds may strive for more nomination rights through negotiations. On the other hand, if there are many investors in the target company, that company and its actual controller may want to control the number of board members. In this case, only shareholders with a certain threshold

of shareholding (such as 5%) can enjoy the right to nominate directors.

Reserved Matters

If a PE fund only serves as a minority shareholder, it may not be able to have dominant power over all major aspects of decision making, so it is typical to negotiate a list of veto rights to retain the veto power of the PE fund on certain matters that are of vital importance, including (but not limited to) major acquisitions or divestitures, changes to the company's capital structure, a change of board composition, related party transactions, employee incentive plans, company listing plans, amendments to the company's articles of incorporation, approval of annual budgets or business plans, and liquidation, dissolution and other major issues in the company. The exact list of reserved matters is typically outlined in the shareholders' agreement or other governing documents.

Information Rights

A PE fund has the statutory rights under PRC Company Law to review relevant company decision-making documents (eg, shareholders' resolutions and board resolutions) and financial documents (including financial statements, accounting books and accounting vouchers). In addition to the statutory rights, a PE fund often negotiates for more information access to the portfolio company through negotiations. This may include regular financial and operational updates, access to management reports, the right to request additional information or reports as needed to monitor the company's performance and specialised audits by its engaged auditors.

9.2 Shareholder Liability

It is very rare for a PE fund to be held liable for a portfolio company's liabilities. Under PRC law, liability is generally attributed to the legal entity of the portfolio company itself, unless the concept of "piercing the corporate veil" can be applied to hold the PE fund liable. This is typically done in cases where the fund has abused the corporate structure or used it to defraud creditors, evade legal obligations or engage in other unlawful activities, effectively disregarding the separate legal existence of the company.

Furthermore, since the PE fund is normally acting as the minority shareholder of the company, it will not participate in the daily operations of the portfolio company. Therefore, the PE fund will not accept any contractual joint liability for the actions of its portfolio company.

10. Exits

10.1 Types of Exit

In general, IPOs, equity transfers, buybacks, mergers, and liquidations are the primary exit routes for PE investors. Among these options, IPOs remain the most common exit path for PE investors. According to a report by Zero2IPO (a research agency), IPO exits accounted for 54% of publicly recorded PE investor exits in 2023. However, it is worth noting that the IPO market in China experienced a temporary slowdown in 2023 due to market and regulatory factors, resulting in a decrease in the number of IPOs. As a result, investors have increasingly turned to equity transfers and buyback transactions as alternative exit strategies. In 2023, equity transfers were chosen as the exit strategy by 24% of PE investors, while an additional 15% opted for buyback exits.

In PE transaction documents, it is customary for PE investors, the target company, as well as its founders and controlling shareholders to agree

on multiple potential exit routes. This provides flexibility to select the most appropriate exit strategy based on the prevailing circumstances at the time of the exit triggers. However, it should be noted that once a PE investor opts for an IPO exit, there are stringent restrictions on equity transfers during the IPO application period. Consequently, the implementation of dual- or triple-track exit plans is rarely observed in practice.

Whether a PE fund can roll over or reinvest upon exit depends on the provisions stipulated in its fund agreement. However, if the PE fund includes special types of investors such as government-guided funds, government investors or state-owned capital investors, there are generally more stringent limitations imposed on fund rollovers or reinvestments.

10.2 Drag and Tag Rights

Drag Rights

It is common for drag-along rights to be included in shareholders' agreements or other governing documents to protect the interests of the majority shareholders and provide flexibility in exit strategies. These rights are particularly important for institutional investors, including PE funds, who consider trade sales as potential exit alternatives.

The drag threshold, which refers to the minimum ownership percentage required for the exercise of drag rights, can vary. In China, the typical drag threshold is often set at a majority ownership percentage, such as more than 50% of the shares with voting rights. This means that if the dragging shareholders collectively hold at least the specified ownership percentage, they can compel the minority shareholders to sell their shares in a transaction. However, the selling party must usually offer the same terms and conditions to the other parties. In addition, the exercise of the drag-along rights is usually required to be based on an agreed valuation price and needs to be completed within a certain period of time.

Tag Rights

Tag-along rights are commonly seen in equity arrangements and are often used in practice. Tag-along rights comprise a group of clauses that together have the effect of allowing one party in a company (normally the minority shareholder) to also take part in a sale of shares by the other party to a non-shareholder under the same terms and conditions. PE investors often seek tag-along rights in situations where other shareholders, particularly controlling shareholders, or founder shareholders are exiting. Institutional co-investors generally enjoy exit rights consistent with those of PE investors.

There is no typical threshold for tag-along rights in China, and the specific tag thresholds can be negotiated and may vary depending on the circumstances of each transaction. PE investors will aim to negotiate more favourable triggering thresholds for tag rights in their favour.

10.3 IPO

In China, the lock-up periods applicable to PE investors in an IPO exit typically differ based on their shareholding and timing of acquisition. For minority shareholders, the lock-up period is usually one year, while controlling shareholders are subject to a longer lock-up period of 36 months. However, for companies without an actual controller, shareholders collectively holding 51% of all issued shares prior to the IPO will face a 36-month lock-up period, excluding qualified VC funds. Moreover, any investor acquiring shares within 12 months before a company's IPO application will be subject to a 36-month lock-up period starting from the date of acquisition.

Following the expiration of the lock-up period, PE sellers holding at least 5% of the shares may encounter certain restrictions and disclosure obligations when transferring shares acquired prior to the IPO. For instance, consecutive block trading or centralised bidding system transfers within 90 days should not exceed 1–2% of the total outstanding shares of the company. Additionally, if a seller holding over 5% of the shares intends to transfer shares via a centralised bidding system, they must announce their intent and the number of shares to be transferred in advance. Occasionally, underwriters may require major shareholders to sign commitment letters regarding share transfers after an IPO.

Furthermore, “relationship agreements” between the PE seller and the issuer on the post-IPO relationship are very rare in China.

Trends and Developments

Contributed by:
Steven Yu and Evan Sun
Global Law Office

Global Law Office (GLO) dates back to 1979, when it became the first law firm in the PRC to have an international perspective, fully embracing the outside world. With more than 600 lawyers practising in its Beijing, Shanghai, Shenzhen and Chengdu offices, GLO is today known as a leading Chinese law firm and continues to set the pace as one of the PRC's most innovative and progressive legal practitioners, including in the private equity and venture capital sector. Not only does GLO have vast experience in representing investors, but it has also extensively represented financing enterprises and founders. With a deep understanding of the best legal practices and development trends of investment terms, the team at GLO knows how to find the most effective balance of interests in terms of negotiation so as to realise all-win results. Vast practical experience and industrial background knowledge enable GLO to enhance value in every step of the client investment cycle.

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China's New Company Law is Significantly Impacting Private Equity Transactions Involving Chinese Companies

The Standing Committee of the PRC National People's Congress adopted the amended Company Law of the People's Republic of China ("New Company Law") on 29 December 2023. The New Company Law, which came into force on 1 July 2024, has substantive changes relative to the previous version (the "2018 Company Law", last amended in 2018) in areas such as capital contribution, equity transfer, capital reduction and corporate governance rules. These changes are having, and will continue to have, a significant impact on private equity transactions involving Chinese companies.

Capital Contribution

One of the major changes introduced by the New Company Law is a strengthening of the capital contribution obligations of shareholders, with a view to protecting the company and its creditors from the abusive use of the previous capital contribution scheme.

Time limit for capital contribution

The PRC Company Law (2028 Revision) ("2018 Company Law") had no statutory timeline for shareholders to pay their committed capital contributions to a company in full. As a result, many companies were established with a large amount of registered capital, while the actual paid-in capital was minimal or nil throughout the lifespan of these companies. In contrast, the New Company Law now requires shareholders of a limited liability company to make capital contributions in full within five years from the establishment of the company.

Grace period

Companies established before 1 July 2024 have a three-year transition period to adjust their capital contribution schedules to meet the new timeline requirement. This grace period is granted by the Provisions of the State Council on the Implementation of the Company Law of the People's Republic of China on the Registration of Registered Capital Management System, promogulated on 1 July 2024.

Consequences of failure to pay on time

Shareholders of a company can agree on a more detailed capital contribution schedule in the articles of association ("AoA") of the company, provided that the time schedule is within the statutory time limit for capital contribution. If a shareholder fails to pay its subscribed capital pursuant to the New Company Law or the time schedule set out in the AoA, then the shareholder in default may be required to:

- indemnify the company against losses caused by such failure; and
- forfeit its right to the portion of the unpaid equity interest upon board resolution after the lapse of a grace period provided by the company.

If the forfeited equity has not been transferred or cancelled within six months from the forfeiture, then other shareholders of the company will be required to make up the outstanding capital contribution in full in proportion to their respective capital contributions to the company. If a shareholder fails to pay its subscribed capital within the statutory time limit, then the shareholder in violation may also be subject to a fine by the government authority of up to CNY200,000, and in more serious cases, a fine of up to 15% of the unpaid amount.

Joint and several liability for outstanding capital

The New Company Law provides that if a founding shareholder of a company (ie, a shareholder upon the establishment of the company) fails to pay the capital contribution according to the AoA of the company, or where the founding shareholder makes its capital contribution in kind and the actual value of the in-kind capital contribution is significantly lower than the capital contribution subscribed to by this founding shareholder, then the other founding shareholders of the company are jointly and severally liable for the outstanding capital contribution.

In light of the above, founders of start-up companies and early-stage investors should carefully consider and determine the amount of registered capital of a company to ensure that all shareholders are able to fulfil their capital commitments to the company on time. In addition, parties to a private equity investment transaction may also wish to clarify in the transaction documents their rights and obligations when a forfeiture of equity interest or a default in capital contribution by a shareholder occurs. For example, the parties may wish to set out in the transaction documents provisions relating to investor's right of first refusal to purchase the forfeited equity, and the defaulting shareholder's liability to indemnify the other shareholders if the latter are forced to make up the underpaid capital as required by law.

Equity Transfer

The New Company Law has several key changes that may affect equity transfer transactions, as follows.

Buyer and seller's joint and several liability

Under the 2018 Company Law, because there was no statutory time limit for capital contributions, unpaid equity was generally not a serious concern to the parties when negotiating an equity transfer transaction. The New Company Law, however, provides that if a shareholder of a limited liability company delays a capital contribution in violation of the AoA and transfers its unpaid equity interest after its capital contribution obligation falls due, then the buyer and the seller are jointly and severally liable for the outstanding capital. The buyer can be exempted from this liability only if it is able to prove that it was not aware, and should not have been aware, that the

transferred equity was unpaid when the transaction occurred. As such, the buyer in an equity transfer transaction should perform a thorough investigation of the capital contribution status of the target company, in addition to requiring the seller to make full representations and warranties with respect to the same. If the equity to be transferred is unpaid, the buyer may require the seller to either complete the capital contribution before the transfer or deduct the unpaid amount from the equity transfer price.

Simplified process

Under the 2018 Company Law, the transfer of equity interest by a shareholder to a non-shareholder third party is subject to the approval of a majority of the other shareholders of the company and the other shareholders' right of first refusal. The New Company Law no longer has this requirement for approval. Under the New Company Law, the seller is required to serve a written notice on the other shareholders of the key terms and conditions of the intended transfer, such as the quantity, price, payment method and period of time for the transfer, and the other shareholders have the right of first refusal to purchase the equity under the same terms and conditions. Shareholders who fail to respond within 30 days from the receipt of the written notice will lose their right of first refusal.

Capital Reduction

Redemption right is a key preference right of investors in private equity transactions, and capital reduction is one of the major ways for companies to fulfil their redemption obligations.

The 2018 Company Law was silent on whether a company may reduce its capital disproportionately amongst its shareholders. In contrast, the New Company Law provides that a company should reduce the capital contribution in proportion to the capital contributions made by its shareholders, except when:

- provided by law;
- agreed upon by all the shareholders of a limited liability company; or
- provided by the AoA of a joint stock company.

As such, although the New Company Law confirms that capital reductions can be made disproportionately amongst its shareholders, such reduction is subject to the following restrictions/requirements:

- for a limited liability company, the redemption right of investors needs to be reflected in a shareholders' agreement entered into by all shareholders of the company;
- and for a joint stock company, investors should make sure that redemption rights are set out in the AoA of the company.

Corporate Governance

Corporate governance structure

The New Company Law makes some significant adjustments to the structure and powers of a company's corporate governance bodies.

I) Company without supervisor

The 2018 Company Law required a company to have a board of supervisors, or one to two supervisors, to supervise the financials of the company and the performance of duties of the directors and senior management. The New Company Law provides that, if unanimously approved by its shareholders, a limited liability company of small scale or with a small number of shareholders may operate without a supervisor.

II) Audit committee

The New Company Law provides that a company may set up an audit committee under the board of directors to function in lieu of a supervisor or the board of supervisors. The audit committee introduced by the New Company Law may vest supervisory powers in the directors. As such, an investor may wish to have to right to nominate a member of the audit committee in its portfolio companies.

III) Employee director

The 2018 Company Law only required state-owned companies to have an employee director on the board of directors. In contrast, the New Company Law provides that any company with more than 300 employees needs to have employee representation on its board of directors unless the company already has an employee representative(s) as a supervisor. The employee director must be elected by the company's employees through employees' meetings or another democratic process.

IV) Legal representative

The 2018 Company Law provided that the chairperson of the board of directors, executive director or general manager of a company may act as the company's legal representative. In contrast, the New Company Law provides that a director or general manager who carries out the businesses of the company may act as the legal representative. The 2018 Company Law was silent on the duties and powers of the legal representative. The New Company Law provides that a company bears the legal consequences of its legal representative acting on the company's behalf, and that the company may request compensation from its legal representative for losses incurred due to acts of the legal representative in violation of laws or the AoA of the company. In light of the importance of the position of legal representative, investors and founders of companies should carefully consider and determine the candidate for this position and design a proper governance structure to strike a balance between:

- allowing a legal representative to perform his or her duties and exercise his or her powers; and
- reducing risk to the company relating to any unauthorised acts of the legal representative.

Duties and liabilities of directors, supervisors and senior management

In comparison with the 2018 Company Law, the New Company Law further elaborates on the fiduciary duty of directors, supervisors and senior managers.

I) Fiduciary duties

The New Company Law provides that directors, supervisors and senior management personnel:

- owe fiduciary duties to the company;
- should take measures to avoid conflicts between their own interests and those of the company; and
- should not use their powers to seek improper benefits.

The New Company Law further requires directors to report to the board of directors or to a shareholders' meeting, and to obtain a resolution in accordance with the company's AoA, before they can directly or indirectly engage in businesses similar to that of the company.

II) Duties of diligence

The New Company Law also provides that directors, supervisors and senior management personnel owe duties of diligence to the company, and must exercise the reasonable care normally expected of management personnel in the best interests of the company when performing their duties.

In light of these changes, directors, supervisors and senior management personnel nominated by investors or founders need to familiarise themselves with these enhanced requirements regarding their duties and obligations. In addition to performing their duties in a faithful and diligent manner as legally required, investors and their nominated directors, supervisors and senior management personnel may wish to take other measures to protect themselves from potential liabilities, such as:

- requiring the company to purchase director and officer liability insurance, entering into a director indemnification agreement with the company; and
- keeping full records of board meeting minutes and other communication materials as evidence for his/her due performance of duties and obligations.

China's New Regulations for Overseas Listing Filing – the First Anniversary Review and Outlook

It has been over one year since 31 March 2023, when the China Securities Regulatory Commission (CSRC) promulgated the Trial Measures for the Administration of Overseas Securities Offering and Listing of Domestic Enterprises (the "Trial Measures"), and five supporting rules for regulatory guidance (collectively, the "New Filing Regulations") came into effect. Based on market observations, the New Filing Regulations have reshaped China's regulatory landscape with respect to the offering and listing of overseas securities by domestic enterprises in the short-to-medium run and are expected to have a profound influence on China's private equity and VC market.

Overview of implementation practice of the New Filing Regulations

According to information publicised by the CSRC, during the period from 31 March 2023 to 30 June 2024, 272 applicants (excluding those issuers who applied for "full circulation" of their existing non-tradable shares in overseas capital markets) were known to submit filing applications to the CSRC. Among these applicants, 158 have obtained the filing notice from the CSRC, accounting for nearly 60% of the total applicants. During the first half of 2024, about 100 applicants obtained filing notices from the CSRC (the number of passing applicants was 57 in 2023), indicating that the CSRC has expedited its steps towards giving the green light to applicants.

According to GLO's rough calculation based on publicly available information from the CSRC, during the period from 31 March 2023 to 30 June 2024:

- about 170 applicants chose the Hong Kong Stock Exchange as the listing exchange, and about 100 applicants chose to list on US capital markets (including Nasdaq, the New York Stock Exchange and other US exchanges not specifically disclosed);
- about 68 applicants chose overseas direct listing as the listing model, and about 204 applicants chose overseas indirect listing as the listing model; and
- among the 204 applicants who chose indirect listing, 55 are issuers operating with a variable interest entity (VIE) structure, and a total

of 20 applicants with the VIE structure have obtained filing notices from the CSRC.

Based on GLO's rough estimate, among applicants who have received a filing notice from the CSRC since the implementation of the New Filing Regulations, the average time from receipt of the filing application by the CSRC to the issuance of the filing notice is approximately five months, with the minimum and maximum review period being less than three months and more than ten months, respectively. Applications for overseas direct listing appear to have a prominent advantage over applications for overseas indirect listing in terms of the average length of time required (four months and six months, respectively). In addition, although the CSRC relaxed its scrutiny of filings by applicants with the VIE structure in the first half of 2024, compared with the filing time of applicants without the VIE structure, it would take on average twice as long for those applicants with the VIE structure (four-and-a-half months and nine months, respectively).

Given the above observations, it can be seen that CSRC filing under the New Filing Regulations has been running smoothly as a routine procedure for more than one year, and that domestic and overseas regulatory processes have been effectively connected to each other, improving the transparency available to applicants and potential applicants. Key elements that may influence the speed of the CSRC's review process include, among others, whether an issuer has adopted or used the VIE structure for overseas listing.

Scope of Domestic Enterprises Subject to Filing Requirement Under the New Filing Regulations

Statutory criteria under the Trial Measures

Article 15 of the Trial Measures provides that, if an issuer simultaneously meets the following criteria, it shall be identified as a domestic enterprise indirectly offering securities and listing overseas:

- in terms of the operating income, total profits, total assets or net assets of domestic enterprise(s) in the most recent fiscal year, any indicator thereof accounts for more than 50% of the relevant data in the audited consolidated financial statements of the issuer in the same period; and
- the main links regarding the business activities are in China, the business activities are mainly carried out in China, or most of the senior management personnel responsible for business management are Chinese citizens or have their main residence in China.

Furthermore, the Trial Measures emphasise applying the "substance over form" principle in particular cases.

Despite the test being stipulated in the Trial Measures, there still remains some ambiguity regarding its interpretation or the discretional application of the "substance over form" principle by the CSRC (eg, how to identify the main links regarding the business activities of an issuer).

Observation of market practice

GLO notes that different issuers with high similarity in terms of the proportions of domestic enterprises' financial (and other) indicators made different choices in their application for the CSRC filing.

In one case, an issuer disclosed in its filing materials for public listing that, although its revenue in the last two fiscal years accounted for more than 50% of its revenue from overseas, since most of its assets and business activities are located in mainland China, it took the initiative to submit an application to the CSRC, and shortly thereafter it was informed in writing by the CSRC that it was not currently covered by the filing requirement. In contrast, another issuer with no essential differences from the above-mentioned issuer believes that it did not need to file with the CSRC (as disclosed in its publicly listed filing materials), and GLO's follow-up public search indicated that this issuer has completed its IPO and listing in the relevant securities market.

Compared with the above two cases, some issuers with business and operations (eg, R&D centre, purchasing and/or marketing staff) in mainland China adopted a more conservative strategy to address the risks of CSRC filing, although strictly speaking their financial and other key indicators do not meet the statutory thresholds. To reduce regulatory uncertainty, such issuers conducted several rounds of communications with the CSRC prior to submitting a formal application and/or voluntarily submitted a filing application to the CSRC, and they each have been granted a "not applicable" clearance or successfully obtained a filing notice.

One more noteworthy case, occurring in May 2024, has come to GLO's attention and merits caution for all market players. As publicly disclosed by the issuer in this case, it received a written notice from the CSRC requiring it to perform the CSRC filing within one week after its receipt of the Notice of Effectiveness of the US Securities and Exchange Commission (SEC) on its share-registration documents. However, it was previously advised by its PRC counsel that, since the issuer generated over 50% of its revenue, net income, total assets and net assets from outside mainland China for the relevant fiscal years, the offering and listing of this issuer are "unlikely" to trigger the filing requirement.

In view of the above-mentioned cases, it is suggested that consideration should be given to whether there are strong connections between the issuers and mainland China by applying the "substance over form" principle, in addition to the statutory indicators. Also, precautionary measures such as pre-application communications with the CSRC would be necessary to avoid or reduce the risk of being unexpectedly prevented from making steps towards overseas securities offering and listing.

Issuers With the VIE Structure

Overview

As of the end of June 2024, a total of 20 issuers using the VIE structure have successfully obtained filing notices from the CSRC; 18 of these were obtained in 2024, accounting for about 13% of the total of 158 issuers who have completed filing with the CSRC.

Issuers who adopt the VIE structure usually use contractual arrangements to hold interests in industrial sectors/areas restricted for foreign investors. However, so far, there have been no specific PRC laws and regulations clarifying the legality of the VIE structure, and the stability and potential risks of the structure have been hotly debated in the market. With the implementation of the New Filing Regulations, the 20 cases passing the filing indicate that the CSRC is becoming increasingly positive and tolerant towards the VIE structure, as long as the red line set by law is not crossed.

Based on GLO's observation, issuers with the VIE structure that have completed the CSRC filing are mainly concentrated in the internet, insurance, travel, education, logistics and medical industries, among others. The main business areas that may involve foreign capital prohibition or restriction include value-added telecommunications, network culture, network publishing, radio and television programme production and operation, surveying and mapping, medical institutions and domestic mail delivery.

Focus on examining issuers with the VIE structure

The New Filing Regulations require applicants with the VIE structure to disclose and clarify the following in the filing documents:

- the reasons for using and detailed composition of the VIE structure;
- legal and compliance risks associated with the VIE structure, as well as risk treatment measures;
- whether foreign investors are participating in the operation and management of the issuer;
- whether there are PRC laws and regulations explicitly prohibiting an issuer in the involved industries/business areas from using the VIE structure; and
- whether foreign participation in the involved industries/business areas is subject to national security review, and whether the issuer is involved in industries/business areas in which foreign investment is restricted or prohibited.

According to the supplementary material requirements for certain issuers publicised by the CSRC, the CSRC's concerns about the VIE structure mainly focus on:

- the overall compliance of the VIE structure (including but not limited to foreign exchange management, overseas investment, foreign investment and tax payment);
- information relevant to the signing of the VIE agreements, in particular decision-making procedures pertaining to the internal performance of the signatories; and
- the transaction arrangements between entities under the VIE structure, including fund transfer between domestic and foreign entities, profit transfer and other aspects of capital flow arrangements.

In view of the above, market players should consider the following reminders:

- at present, there is still lack of clear industry-specific guidelines regarding the extent to which the VIE structure is permitted for issuers with operations in a particular industry/business area in which foreign investment is restricted;
- issuers who intend to use the VIE structure for overseas securities offering and listing should be more cautious when analysing their business necessity and legal viability to adopt the VIE structure, taking into account the examination focus and concerns of the CSRC in relation to reviewing the filing applications, and where there is an existing VIE structure – if the VIE structure is not workable – unwinding or dismantling it might be a possible solution for passing the filing; and
- for issuers who intend to use the VIE structure for overseas securities offering and listing, historical compliance issues that remain unresolved in connection with or arising out of the VIE structure should be given full attention and be solved in a timely manner (before the issuance of the filing notice by the CSRC at the latest).

Conclusion

The introduction and implementation of the New Filing Regulations by the CSRC is an important measure that has reshaped China's regulatory landscape for overseas securities offering and listing by domestic enterprises. After more than a year of exploration and implementation, the filing mechanism has become more mature and transparent, and is more compatible with the practice of overseas listing in Hong Kong SAR, the United States and other jurisdictions. Even the VIE structure, which is generally considered more "difficult" by the market, has been given the green light in successful cases. Market players (domestic enterprises and global investors in the PE/VC areas) should adhere to the compliance-based principle by keeping a close eye on China's latest regulatory trends, so that they can formulate the most suitable investment/financing and divestment/listing strategy and action plans.

EGYPT

Law and Practice

Contributed by:
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Shahid Law Firm has over 35 years of experience in the legal market. Its highly qualified team of lawyers provides a broad spectrum of services to leading multinational corporations, industrial conglomerates, insurance companies, start-ups and high-net-worth individuals and families. The firm advises clients in pharmaceuticals, energy & power, oil & gas, mining, manufacturing, leisure and hotels, consumer products, food & beverage, banking & finance, information technology and telecommunications. The firm's strength lies in its understanding of client needs which, coupled with knowledge of the Egyptian legal system, longstanding experience in transactions, dispute resolution and regulatory matters, as well as close ties to other leading firms in the region and beyond, ensures that clients obtain the best legal service. The firm is amongst the few MENA-based firms that provide services in English, French, Italian, German, Spanish, Portuguese and Arabic. Diversity in terms of nationality, ethnicity, gender, age and religion is the cornerstone of Shahid Law.

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SHAHID
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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

Despite Egypt's constant legislative reforms, the Egyptian president's visits abroad to attract foreign direct investment, and economic reforms undertaken by the Egyptian cabinet to help boost the number of transactions, foreign investors continue to show reluctance to invest.

Funds are needed to intervene and seize the business opportunities demonstrated by the high demand by SMEs and start-ups for financing. Private equity is now acting as an alternative solution for financing and to fill the gap between the available channels of financing and the increased demand on the part of SMEs and start-ups.

As part of enhancing its economic and investment climate, Egypt is currently deliberating and finalising several significant reforms and amendments to its investment and importation laws, with the aim of encouraging foreign direct investment in Egypt with additional incentives and less restrictions. These reforms and incentives could be manifested by enacting several new laws to support current global investment trends.

Incentives for Green Hydrogen Production Products

Egypt recently introduced in January 2024, Law No 2 of 2024 providing incentives to produce, transmitting, storing or distributing green hydrogen and its derivatives through establishing relevant projects companies and operational branches. The law also provided for the establishment requirements, wide tax and expenses exemptions, facilitating the hire of foreign employees and most importantly lessen the administrative burdens of importing raw materials and obtaining the golden licence.

Foreign Investors' Ownership of Desert Lands

Law No 11 of 2024 which was introduced in February 2024, amending some of the restrictions of desert lands ownership, provided an exception to foreigners to own desert lands in partnership with Egyptians whose ownership shall not be less than 51%.

New Amendment to the Importation Law

In a prominent move, Egypt has enacted Law No 173 of 2023 and got practically enforced in early 2024. This amendment introduces an important exception, allowing companies directly and fully owned by foreigners to register in the Importers' Registry as an exception to the standard regime

requiring an Egyptian ownership of at least 51% of the company applying for a licence. While this exception has limitations regarding the total period of registration which shall not exceed ten years from the date thereof, extendable for one additional ten-year period only, subject to a Cabinet Decree based on the recommendation of the Minister concerned with Foreign Trade Affairs; this amendment can be the start of a more stretched importation and commercial dealings climate, allowing simpler business structures.

Egypt's Sub-fund for Financial Services and Digital Transformation

In a recent remarkable move, the Board of the Egyptian Sovereign Fund issued Decree No 7 of 2020 promulgating the establishment of a sub-fund, namely, Egypt's Sub-Fund for Financial Services and Digital Transformation (the "Sub-Fund"). The main purpose of the Sub-Fund is to devote investments to non-banking financial services, digital transformation and financial inclusion, including in insurance and insurance brokerage services, real estate financing, financial leasing, factoring, and micro-financing.

This important step has encouraged private equity funds to expand, and to direct more investment into companies operating in, among others, the fintech sector, which underpins the odds of observing further activities in private equity M&A transactions in the Egyptian market in general, and in the fintech sector, in particular.

Growth Investment Funds

According to the head of the Financial Regulatory Authority (FRA) in his statement in July 2022, the FRA has granted licences to ten newly established funds in Egypt, making the total number of investment funds in Egypt approximately 122 growth investment funds, focusing on medium-sized enterprises and family businesses. Their main function is to act as agents for growing businesses, and simultaneously foster and monitor expansion to ensure a sustainable future for such businesses.

1.2 Market Activity and Impact of Macro-Economic Factors

Certain sectors dominate the private equity M&A transactions scene in Egypt, as the appetite of the real estate, healthcare, education, fintech, and renewable energy sectors for private equity funds is steadily increasing and is of paramount importance.

The main challenges that those industries regularly face and that certainly affect the parameters and considerations of private equity M&A transactions are mainly attributed to the high interest and inflation rates which are making major investment opportunities and the achievement of high returns more challenging. Needless to highlight that the current geopolitical tensions within the region, affected (even if slightly) the investors' appetite into pursuing investments opportunities depending on complex logistical cycles and continuous supply of raw materials for manufacturing purposes.

The significant increases in the interest rates and the ensuing increased cost of borrowing, negatively affect the allocated capital available for investment and subsequently drive investors to reshape their financial structure and considerations to mitigate the high financing costs. Moreover, in the current environment of high interest and inflation rates, investors may need to hold onto their investments for additional longer periods before applying any exit strategies so that they can achieve profitable returns and meet the commercial and business parameters of their investment plans.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Legislative Development in the CML

In 2018, a significant legislative development was introduced to the Capital Market Law (CML), when a newly incorporated Egyptian private equity company became obliged to be in the form of a CLS structure (ie, a company limited by shares). This structure ensures a significant advantage for the limited partners, namely, it confines their liability to their contribution to the company's share capital, provided that they do not engage in the company's management. By contrast, the CLS's manager will be the general partner in the company, which triggers the illimitation of its liability towards the limited partners.

Financial Regulatory Authority Decrees

Accordingly, in June and September 2018, the FRA issued two executive decrees, whereby a private equity fund must satisfy certain conditions for its establishment and licensing in terms of its required legal structure, capital, partners and their respective ownership percentage and qualification, purpose, management, the fund's investment ratios, and managers (including the general partner of the fund). It is worth highlighting that a private equity fund's activity will be limited to private equity and it must apply for a licence in order to undertake venture capital activity.

Prior Approval for the Direct or Indirect Acquisition of a Business

Another significant legislative change was put in place, whereby some laws have been amended to require prior approval in the case of direct or indirect acquisition of a business. Hence, whenever a private equity fund opts to acquire stakes in the target company, whether directly or indirectly, such acquisition will require the prior approval of the competent local regulator, depending on the activity of the target company.

New Decree No 99 of 2021 Regarding Medical Industrial Facilities

Another recent development, in this case with respect to the operation and legal disposal of medical industrial facilities, was the issuing of the New Decree No 99 of 2021, on 2 March 2021 (the "Decree") by the Egyptian Drug Authority (EDA), whereby no medical industrial facility can be established or expanded unless the EDA approves this.

Furthermore, the Decree prohibits any sort of legal disposal (eg, sale and purchase) of medical industrial facilities unless prior notification is served to the EDA via certain forms pre-set by the EDA. To this effect, prior notification will be associated with the necessary undertakings, as determined by the EDA, to ensure the availability of the medicine in the market.

In the context of private equity funds' M&A transactions, one of the conditions precedent that is likely to be envisaged in future transactions relating to medical industrial facility acquisition, is to notify the EDA. However, the implementation of said Decree is to be closely monitored to verify compliance with the new notification requirements.

New Amendments to the Egyptian Competition Law

Significant amendments were introduced to the Egyptian Competition Law (ECL) in December 2022, whereby, similar to other jurisdictions, the parties to a transaction shall seek the prior approval of the Egyptian Competition Authority before the consummation of the transaction, subject to the occurrence of minimum turnover

thresholds and other requirements, rendering certain transactions notifiable before the authority. While the ECA announced in early 2023 that the implementation of the new regime is on hold and that the market is considered in a "silent period", where notification of acquisitions will not be necessarily required, until the issuance of amendments to the executive regulations of the Law (the "ER"). The long-awaited ER was finally issued on 7 April 2024, by the issuance and publication of Prime Minister's Decree No 1120/2014 whereby the new pre-merger notification regime has finally came to force.

Golden Licences for Investment Projects

With the aim of simplifying the procedures for investors in relation to their projects, investors shall be entitled, subject to the satisfaction of certain conditions, to obtain a "Golden Licence", which, although not a waiver from applying and obtaining all required regulatory approvals and licences from various governmental bodies, shall shorten and simplify such procedures in a one-step approval that reduces time and effort. The introduction of this regime is a step towards overcoming bureaucratic challenges and facilitating licensing procedures and accordingly the investors' appetite for investments, which will positively strengthen and develop the investment climate.

Digital Bank Licensing Rules

As part of Egypt's plan for digital transformation, the Central Bank of Egypt has issued a circular in July 2023 regulating the licensing and registration of digital banks, which ultimately provide banking services through digital channels and platforms, by means of financial technology. This circular represents the continuous efforts of the Central Bank of Egypt to achieve the financial technology transformation which will have significant impacts on the country's banking system.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Generally, the regulatory restrictions in Egypt vary from one industry to another. For example, key restrictions can be highlighted, as follows:

- it is necessary to obtain the prior approval of the FRA on the transfer of ownership of a business (eg, acquisition of 10% of the voting rights or shares of a holding company and companies operating in a non-banking financial activity);
- it is necessary to obtain the prior approval of the General Authority of Investments and Free Zones (GAFI) on the transfer of ownership of companies established in a free zone;
- it is necessary to obtain the prior approval of the Central Bank of Egypt to change ownership of an Egyptian licensed bank;
- it is necessary to obtain the prior approval of the Ministry of Health for the transfer of ownership of hospitals;
- it is necessary to obtain the prior approval of the Ministry of Education for the transfer of ownership of schools;
- foreign ownership restrictions apply in some industries such as a commercial agency, where the agency company must be fully owned by Egyptians, while 51% of the share capital of a company operating in importation activity must be owned by Egyptians;
- it is necessary to obtain the prior approval of the Sinai Development Authority on the transfer of shares of a company owning assets or operating in the Sinai Peninsula; and
- it is necessary under the new amendments introduced to the Egyptian Competition Law, to seek the Egyptian Competition Authority's approval on reportable transactions, as a pre-closing obligation of the parties to a transac-

tion and to also seek the prior approval of the FRA in relation to transactions affecting FRA activities including the non-banking financial and insurance sector.

The above highlighted key restrictions will have to be considered while determining the following parameters of transactions:

- timelines;
- closing conditions;
- structure and implementation thereof;
- values and considerations;
- transaction documents and ancillary agreements; and
- parties' representations and warranties.

Moreover, the above restrictions are being closely monitored and applied by the relevant governmental authorities, especially in the healthcare, education, fintech and renewable energy sectors. Transactions of these natures can be also evaluated from a national security perspective, though the specific parameters and presumptions can be difficult to quantify. The review of transactions and the parties involved from the national security angle is done on a case-by-case basis with wide spectrum of factors involving the nature of the transaction, the insolvency of the parties involved and the potential national interests or concerns (like competition and abuse of dominance concerns).

Anti-bribery, Sanctions and ESG Compliance Issues in 2022

The Egyptian legislature has drawn up a package of laws governing the role of bodies and agencies working in the prevention and combating of corruption, as well as a legislative system that criminalises many of the corruption crimes as set out in the UN Convention. Such package of laws is not recent; however, the manner of its implementation has changed and now shows the seriousness of the president and some officials in combating corruption, through efforts to amend and enact laws, use digitalisation of services provided to the public (eg, payment of utilities may now take place via payment aggregator channels), and use the principles of governance and some matters related to the establishment of some courts to shorten the litigation period.

As for ESG compliance, financial institutions now show an appetite for financing environmentally friendly projects, such as clean and renewable energy projects; in addition to the projects that take into account the social component, such as, not only small, medium and micro-industries projects, but also labour-intensive projects that create more job opportunities and help to reduce poverty and raise the standard of living in the neediest areas.

4. Due Diligence

4.1 General Information

There is no specific level of detail for a due diligence exercise, as it varies depending on the acquirer, the target's activity, and compliance with the laws and regulations of the industry. While some acquirers may opt for limited high-level due diligence with a focus on key red flags, others may prefer to carry out full, detailed due diligence.

Customary legal due diligence usually covers key areas, inter alia, required licensing, full review of the constitutional documents to assess if any restrictions and third-party consents are required pertaining to the material agreements concluded by the target company, an assessment of the employees' rights, and the general compliance of the target company with Egyptian

laws. However, the buyer may require additional/specific due diligence to be exercised by its advisers (eg, technical, tax, financial, commercial, environmental and human resources due diligence exercises). Legal due diligence may be conducted via a virtual data room or in the physical presence of the buyer's advisers at the target's premises, but virtual data room due diligence seems to be preferred.

4.2 Vendor Due Diligence

Vendor due diligence is not commonly conducted in Egypt. However, while buyers do not generally opt to rely on such reports (unless in the case of extensive warranties), sellers are generally advised to consider conducting a seller/defensive due diligence in order to ensure an investable vehicle for investors, which should also have an impact on the evaluation process.

Depending on any existing business arrangement between the vendor and buyer and the binding nature thereof, vendors and their legal advisers can generally make available, among other documents, the following reports and information:

- financial statements, including the income and cash flow statements and balance sheet;
- business licences and permits;
- material contracts and agreements with third parties; and
- tax returns.

5. Structure of Transactions

5.1 Structure of the Acquisition

Generally, there is no major difference between a privately negotiated transaction and an auction sale. However, in an auction sale where there is competition between the bidders to win the sale, the terms of the acquisition may be strictly negotiated before being accepted by the seller, as the seller is in a better position to demand the most favourable terms and conditions.

5.2 Structure of the Buyer

Most transactions involving a private-equity-backed buyer are managed as indirect acquisitions for ownership restructuring purposes. Hence, the private equity fund usually establishes a special-purpose vehicle (SPV) to contract with the seller, depending on the proposed deal structure, and the partnerships of the private equity fund do not directly enter into any transaction documents with the seller, except for the equity commitment letter with the newly established SPV. The SPV is commonly owned by an independent offshore investment arm and/or a BidCo, established for that purpose for structuring and future exits/attraction of investments purposes.

5.3 Funding Structure of Private Equity Transactions

Private equity deals are normally financed through equity commitment provided by the fund to the SPV, or they may be financed by a mixture of both the equity committed to the SPV and the finance provided by the third-party lender (eg, banks). For that purpose, several deals also witness the implementation of a corporate guaranty mechanism, especially if any of the designated investment arms related to any of the parties to the transactions are newly established entities which can raise concerns on the ability thereof to commit to its part of the transaction's current or future financings. In those cases, and for the other party's comfort, this financing party's obligations can be guaranteed by a guarantor (normally its parent company or one of its related companies) whereby the guarantor will agree to assume responsibility for the obliga-

tions of the financing party should the latter fail to fulfil its financing obligations. The corporate guaranty can typically be documented in a written agreement, and the guarantor can either sign the transactional documents or execute a separate guaranty agreement to be treated as one of the transaction's ancillary documents. An approach which became more commonly used, is to implement and establish offshore structure and investment arms allowing investors to tap into wider pool of investment opportunities and attract different financing to ultimately secure more funding to the SPV while benefiting from more stretched taxation and governance regimes. In all cases, the SPV should have sufficient funding to finance the deal, which is usually made available by the private equity fund to the SPV at the time of executing the sales purchase agreement (SPA). Most deals witnessed in the past three years indicate a tendency on the part of key private equity funds in the Egyptian market to acquire a minority rather than a majority stake.

5.4 Multiple Investors

While a private equity consortium is observed in a few transactions in the market, this is not yet common in Egypt. Indeed, the private equity fund holds majority equity on the offshore SPV level. Meanwhile, a minimal ratio (minority) of around 10% will be held by the management in most cases. However, a significant part of equity funding is often secured via a preferred equity instrument, which has a preferred return under the fund management agreement, as common equity will not suffice to secure the equity funding of the transaction, due to its minimal ratio to the total equity funding.

In the past, the market witnessed the investors' increased interest in forming consortiums comprising of private equity funds and corporate investors in transactions, especially in the sector of oil and gas and renewable energies or in transactions involving state-owned entities.

Co-investment Right

While the co-investment right can be a right granted to the investor under the management agreement, the investor may not show an interest in co-investing alongside the private equity fund, especially at the very beginning of the transaction up to its closing, based on cost-efficiency and the uncertainty of the transaction. However, investors may opt to use their co-investment right at a later stage following the closing, on a higher-level structure of the SPV and management team. These are the passive stakes/investments managed by the private equity manager, which ultimately aims to increase the financial interest of its investors in such investment.

Having said that, in acquiring a larger stake, the co-investors may engage together with the private equity fund at the same level as the management team, in which case, minority protection will be given to the co-investor (eg, the right to access information).

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

The Locked-Box Mechanism

While the completion accounts mechanism is used in a few cases in the market, the locked-box mechanism remains the dominant form of consideration structure in Egypt, as it is particularly suited to transactions where the parties require economic certainty in case of, for example, private equity exits. Hence, the price payable for the target is based on a balance sheet prepared at an agreed date prior to completion

providing for a fixed equity price. Generally, the most common locked-box date used is the target's last financial year-end.

In this respect, and although the locked-box is protected by restrictions on "leakage" and "permitted leakage" under the SPA, the buyer, for certainty purposes, may require the audited financial position of the target company for a specific period preceding the completion. The buyer may also require the management accounts covering the gap between the audited financials and completion, especially when the completion date falls sometime after the locked-box date.

The Earn-Out Mechanism

Unlike the foregoing, the earn-out mechanism can be observed in transactions where a private equity fund is not involved. Furthermore, the involvement of a private equity fund will definitely affect the transaction's structure, but not the type of consideration mechanism, as the same consideration mechanism tends to be used in most transactions involving a private equity buyer.

The SPA usually provides a level of protection, which is commonly given by the seller not the buyer (eg, restrictions on "leakage" and "permitted leakage" and business warranties in relation to accounting and the financial position of the target). Said level of protection usually remains the same, irrespective of the nature of the seller, whether a private equity seller or corporate seller.

6.2 Locked-Box Consideration Structures

While the parties agree to a specific indemnity for the leakage, which, for example, can be on an Egyptian pound-for-pound basis, the interest charge on leakage is rarely adopted in the market. However, the buyer has recourse to the general rules of interest charged under Egyptian law.

6.3 Dispute Resolution for Consideration Structures

Allocating a specific dispute resolution mechanism for the consideration structure is not common in Egypt. The parties usually agree to a dispute resolution mechanism for the entire share purchase agreement and, in particular, the parties usually agree to specific indemnity (eg, Egyptian pound-for-pound indemnity for leakage in the case of a locked-box mechanism), which, in most cases, is identified and settled before completion of the transaction. It is not common in Egypt to have a dedicated expert to play the role of mediator between the parties in case of a dispute, however, as part of the dispute resolution mechanism (which is, as highlighted, agreed for the entire share purchase agreement), parties may try and resolve their dispute amicably within an agreed maximum timeframe before resorting to the agreed dispute resolution mechanism.

6.4 Conditionality in Acquisition Documentation

The level of conditionality depends on the outcome of the due diligence exercise, which is likely to identify certain mandatory and suspensory regulatory conditions (eg, FRA approval, GAFI approval and recently the consent of the Egyptian Competition Authority), along with other conditions, such as third-party consents or shareholder approval. The material adverse change/effect is one of the key elements of the SPA and is heavily negotiated between the parties, which may trigger the termination right of the buyer. Indeed, one of the most common conditions observed in the SPA is third-party consent, if it is provided under a material contract to which the target is a party.

6.5 "Hell or High Water" Undertakings

In Egypt, the buyers are usually conservative, so they are not willing to accept "hell or high water" undertakings, especially where this approach conflicts with the fiduciary obligation of the private equity fund towards its investors. Furthermore, the hell or high water approach triggers several implications affecting the consummation of the transaction, as well as contingent liability that will likely be incurred by the fund. Hence, the hell or high water approach is not usually adopted by private equity funds in the Egyptian market and accordingly, the new EU FSR regime would not be typically featured in such types of undertakings.

6.6 Break Fees

Although break fees and reverse break fees are not mandated or regulated under Egyptian law, in private M&A break fees are commonly incorporated under the SPA, in favour of the buyer not the seller, since the likelihood of incurring significant expenses is to the buy-side not the sell-side. Although break-up fees for public transactions are not prohibited by law, they are not common or customary.

6.7 Termination Rights in Acquisition Documentation

As with any other acquisition transaction, termination rights are vested in both parties on the occurrence of certain events specified under the acquisition documentation. Material adverse change/effect and non-satisfaction of conditions precedent (eg, not obtaining the prior approval of the regulator or third-party consents) are key events that can trigger termination of the transaction, unless waived by the aggravated party. Long-stop dates vary depending on the contractual agreement of the parties and the expected timeframe during which each party will need to fulfil its pre-closing obligations especially obligations related to securing governmental approvals and consents.

6.8 Allocation of Risk

Generally, private equity sellers will attempt to limit their liability arising from the sale of the portfolio company, in order to return the proceeds to the investors in a timely manner, and maximise their return on investment, knowing that any unreasonable extension of the return time will affect the fund's performance. Therefore, private equity sellers tend to assume minimal liability under the SPA of the transaction.

Where liability is assumed by a private equity seller, the private equity seller needs to make sure that warranties given under the SPA will not give rise to any liability. Thus, typical warranties given by the private equity seller under the SPA will be limited to the fundamental obligations and warranties (ie, to transfer the shares free of encumbrance, the fund's ownership of the shares, the power and authority to enter into the SPA, permission of leakage, and running the portfolio company in the ordinary course of business until completion).

Furthermore, the private equity seller will opt to negotiate the shortest possible perception period of the warranties given under the SPA, which in most cases ranges between six and 24 months. In the event that the private equity fund is a buyer, the fund expects to receive a list of warranties (ie, business and core warranties), subject to the outcome of the due diligence.

6.9 Warranty and Indemnity Protection

Private equity sellers typically provide fundamental business and core warranties (eg, legal title to the shares, the power and authority to enter into the SPA, accounting, litigation, solvency, insurance, etc).

In Egypt, the management team does not usually participate in shareholding at the target level. Furthermore, in most transaction documentation, whether or not the management team is involved in the board of the target, the customary business warranties will be provided by the seller (eg, accounting, tax, employment, insurance, litigation, compliance with law, accuracy of the disclosed document/information, etc).

Warranties are typically capped under the SPA in terms of limitation of time and quantity as the time limitation of most warranties ranges from six to 24 months, except for the tax warranty, which is typically tied to the lapse of the statute limitation (ie, five years). As for the quantity, core warranties (eg, title of the shares and power and authority) are typically capped at 100% of the transaction consideration, while business warranties (eg, employment, litigation, compliance, etc) are capped at 25% of the transaction consideration.

6.10 Other Protections in Acquisition Documentation

Warranty and indemnity insurance is not common in Egypt. The private equity seller does not provide any further protections, other than the ordinary core and business warranties. Nonetheless, the parties may agree to cover certain risks post-closing through financial adjustments.

For example, operational licences and tax-related risks are a common concern among businesses in Egypt. Thus, one common approach to safeguard the purchaser is to retain a portion of the consideration for an agreed period to cover any potential tax exposure. Purchasers tend to make deferred payments, pricing adjustments and escrow arrangements rather than resort to indemnity claims covering potential liabilities.

6.11 Commonly Litigated Provisions

Litigation is not common in M&A transactions or private equity transactions in Egypt, as the parties usually agree to institutional arbitration as a way to solve disputes. The most commonly disputed clauses may be, for instance, a MAC, breach of warranties (ie, core warranties and business warranties), and price adjustment. However, the potential rise in disputes when a private equity fund is involved is minimal, as private equity funds usually tend to undertake comprehensive due diligence on the target company before execution of the transaction documents, so that they can eliminate the possibility of post-closing disputes as much as possible.

7. Takeovers

7.1 Public-to-Private

Public-to-private transactions are not common in private equity transactions in Egypt.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Any corporate entity established in Egypt and any investment project carried out in Egypt involving a minimum of (10%) foreign shareholding for non-listed companies or (2.5%) for listed companies (excluding any company operating locally by virtue of a concession agreement) are now required to submit disclosure/reporting forms to GAFI on a quarterly and annual basis, or in the event that certain articles of a company's statutes are amended. Furthermore, according to the FRA's listing rules, shareholders are obliged to notify the FRA if their shareholding, voting rights, subscription percentage (directly or indirectly) reaches or falls below 5% and multiples of 5%. This also applies to employees, board members and their related parties, whose respective shareholding, voting rights, subscrip-

tion percentage (directly or indirectly) reaches or falls below 3% and multiples of 3%.

7.3 Mandatory Offer Thresholds

A recent amendment has been introduced to the CML with respect to the thresholds requiring submission of a mandatory offer to the minority. The new amendment introduced certain thresholds that can be summarised, as follows:

- a buyer acquiring one third (whether directly, indirectly or through related parties) of the share capital or voting rights in a listed company;
- a buyer owning one third (whether directly, indirectly or through related parties) of the share capital or voting rights in a listed company and increasing their existing equity/voting rights to 50%, or acquiring more than 5% within 12 consecutive months;
- a buyer owning 50% (whether directly, indirectly or through related parties) of the share capital or voting rights in a listed company, and increasing their existing equity/voting rights to two thirds, or acquiring more than 5% within 12 consecutive months; or
- a buyer owning two thirds (whether directly, indirectly or through related parties) of the share capital or voting rights in a listed company and increasing their equity/voting rights to three quarters, or acquiring more than 5% within 12 consecutive months.

7.4 Consideration

Consideration is dependent on the target's shares. For unlisted shares, the consideration may be in cash and/or in kind, while for listed shares, the consideration for a mandatory tender offer may be all in cash, or a mixture of cash and shares.

7.5 Conditions in Takeovers

The CML requires a mandatory tender offer to be final and not subject to conditions. In exceptional cases, and subject to the FRA's approval, an offeror can make a mandatory tender offer conditional on the acquisition of a minimum stake in the voting rights or the capital of the target company. Offers can be conditional on acquiring at least 51% with the purpose of controlling the company, or 75% if the acquisition is for the purpose of a merger.

If, however, the shares offered for sale do not meet the specified minimum stake – 51% or 75% (as the case may be) – the offeror may not acquire the offered lower stake without obtaining the FRA's prior approval. Furthermore, if the tender offer is through a swap of shares that will be issued through a capital increase, the offer must be conditional on the company's approval of the issuance of the shares.

Financing as a Condition

With regard to financing as a condition, the offer proposal submitted to the FRA must include a confirmation from a licensed bank in Egypt evidencing the availability of the financial resources to fund and cover the offer. Accordingly, unless there is confirmation of financial solvency, the FRA should not accept the offer proposal.

Break-Up Fees

Neither break-up fees nor reverse break-up fees are mandated or regulated by Egyptian law. In private M&A, it is common that parties agree on break-up fees. Although break-up fees for public transactions are not prohibited by law, they are not common or customary.

Furthermore, the FRA is entitled, during the offer's validity period and up to five days before the lapse of this period, to accept a competitive

offer, hence the impracticability of break-up fees in tender offer transactions.

Generally, and despite the parties' agreement on break-up fees or liquidated damages, or both, Egyptian law allows a party to claim reduction of agreed damages, to the extent that the agreed amount is deemed excessive compared to the actual damages occurring from the break-up.

7.6 Acquiring Less Than 100%

If a private equity bidder acquires less than 100%, the bidder can enter into a shareholders' agreement, where additional governance rights can be granted to the bidder under said agreement, but this would trigger a disclosure obligation. In fact, the squeeze-out mechanism is not recognised under Egyptian law, thus, there is no mechanism available to compel minority shareholders to sell their stakes. However, the CML has allowed minority shareholders to request and oblige majority shareholders to acquire their stake.

7.7 Irrevocable Commitments

While conceptually, irrevocable commitments can be agreed in the case of an unlisted target company, irrevocable commitments are rare in the case of listed target companies to minimise the level of disclosure, especially since the FRA is entitled during the offer's validity period and up to five days before the lapse of this period to accept a competitive offer, which illustrates the impracticability of irrevocable commitments in tender offer transactions.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentivisation is a cornerstone feature of the private equity market in Egypt. However, as stated previously, the level of equity is minimal and it is usually dependent on the adopted structure and the agreement between the relevant parties. It is generally about 10%.

8.2 Management Participation

The institutional strip structure dominates the private equity transactions scene in the Egyptian market. In fact, most private equity transactions are indirect, being carried out by an offshore investable arm SPV of the private equity fund.

8.3 Vesting/Leaver Provisions

Typically, managers can be incentivised under management incentive schemes, where incentive shares can be acquired by managers concurrently with the private equity fund at the time of closing the transaction. The main purpose of vesting provisions is to incentivise managers to maintain their high performance with the private equity fund and to retain the "right" deal executives until the end of the private equity fund's investment period. Normally, the vesting provisions, including the respective calculation, may be identified under the constitutional documents of the offshore SPV, which typically categorise "good leavers" and "bad leavers".

8.4 Restrictions on Manager Shareholders

The principal management agreement entered into by the general partner and the limited partners usually provides for certain restrictions on the limited partners in relation to specific matters (eg, the operation and management of the private equity fund), which is emphasised by Egyptian law as well as under the CLS structure. As a result, it is common that the supplementary agreement entered into with the managers of the private equity fund provides for certain restrictive covenants (eg, non-compete, non-solicitation). However, such covenants should

not be excessive in terms of the length of the restrictive period.

8.5 Minority Protection for Manager Shareholders

Management and Voting Rights

As a general concept, minority shareholders are protected by the applicable law, and manager shareholders owe a fiduciary duty to the other shareholders (ie, the limited partners). As a further protection for limited partners under the CLS structure, the general partner(s) is/are not allowed to dispose of its allotment unless the extraordinary general assembly approves this. Moreover, in the CLS structure, limited partners' liability is confined to their contribution, as they provide capital but cannot make managerial decisions and are not responsible for any debts beyond their initial investment. On the other hand, the liability of the general partner(s) for the debt of the private equity fund is unlimited, since the general partner(s) is/are responsible for the daily management of the limited partnership and is/are therefore liable for the private equity fund's financial obligations, including debts and litigation.

Anti-dilution protection is generally granted to shareholders (including manager shareholders) under the law, but it is always subject to exercising a subscription right in the event of any capital increase of the fund. However, in the case of a joint-stock company structure, exercising a subscription right remains optional, and this can be further protected contractually between the manager shareholder and other shareholders. However, in a CLS structure, the general partner's allotment is always half a per cent of the other limited partners' share in the fund, which is an obligatory requirement for a private equity fund to retain its licence.

Business and Holding Structures

While the law specifies provisions with respect to management and voting rights under the CLS structure, the management agreement may entail further technical details with respect to management of certain matters involving the business and holding structure (eg, multi-vehicle adjustments and related investment vehicles of a private equity fund).

Under the CLS structure, the law grants the entire management to the general partner (including managers), and hence, the right to control exit from the private equity fund. However, the management agreement usually organises the exit right to entitle the partners (general and limited) to vote for the exit.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

From a governance standpoint, it is typical for a private equity fund shareholder to have control over the target's business. This is usually achieved under the shareholders' agreement, where the private equity shareholder is entitled to a certain number of board seats, in addition to certain reserved matters, requiring the approval of the private equity shareholder to pass, for example:

- capital increase;
- issuance of any shares or equity-linked securities;
- reduction in capital;
- redemption of shares;
- granting of options including the performance incentives programme;
- changes to class rights or rights issue, approval of the annual financial statements,

balance sheet, profit and loss statement and cash flow statement of the target;
- permitting any material change in the accounting policies and principles adopted by the target company;
- approval of the target's business plan and annual budget and any material deviation from this;
- approval of the target's related-party transactions;
- declaration, distribution and/or payment of dividends by the target company to its shareholders or their direct parent companies; and
- investment or participation by the target in any entity.

9.2 Shareholder Liability

In principle, the liability of shareholders is fundamentally organised under Egyptian companies' law. In this respect, the shareholders of capital corporate entities (ie, limited liability companies and joint-stock companies) are only liable for the acts of the company to the extent of their contribution to said company's capital, unless such act implies criminal liability or grants a favourable advantage to specific shareholder(s) without regard for the interests of other shareholder(s) or the company. Therefore, one of the key priorities of private equity funds is to apply a proper governance regime in their portfolio companies to minimise the level of exposure, which is perfectly accomplished by imposing a compliance policy in said portfolio companies.

10. Exits

10.1 Types of Exit

The holding period for private equity transactions is usually tied to two main elements, namely, the life cycle of the principal fund and the achievement of the business plan to ensure greater return on investment (ROI) on the portfolio companies. This would normally take up to five years. Commonly, private equity funds choose the IPO as a strategic means of exit. However, this is still subject to several factors and market conditions.

While private equity funds can consider other exit strategies, the "dual track" and "triple track" are not common in the market. Reinvestment upon exit is unusual in private equity practice, however, the fund remains fixable to reinvest, depending on its investment strategy.

10.2 Drag and Tag Rights

Drag rights are typically provided under transaction documents. Although the drag right is commonly granted to the majority shareholder, a private equity minority shareholder can stipulate this right under the shareholders' agreement to force the majority of shareholders to co-sell their shares to a third-party buyer on the same terms and conditions. The drag right is commonly exercised on the entire shares of the majority shareholders of the target company.

As private equity funds adopt the institutional strip approach, the "institutional co-investor" scenario does not occur in practice at the shareholding level of the target company. Based on the institutional strip model, private equity investors (ie, the manager shareholder and private equity fund) are aligned under one vehicle (ie, the offshore SPV). The tag rights are therefore granted to the offshore SPV under the shareholders' agreement entered into with the other shareholders of the target company, according to which, the offshore SPV can exercise the said right, at its sole discretion, and co-sell the minority shares to a third-party buyer on the same terms and conditions.

10.3 IPO

Other than a statutory lock-up period for a main shareholder in the case of an IPO (ie, two fiscal years), the lock-up period between the private equity seller and the other shareholders is generally agreed for three years. The IPO arrangement can be conducted gradually in several phases, which may have a positive impact on the value of the remaining equity held by a private equity seller until the full exit. Meanwhile, relationship agreements may be put in place between the private equity seller and the target company, subject to disclosure requirements and corporate approvals.

Private-equity-led IPOs generally take into account some key considerations, for example:

- the timing and duration of investments and the exit strategies thereof;
- the valuation of the company affecting the pricing of the IPO and the amount of capital injected;
- the strategy of using the IPO proceeds for the company's plans; and
- the type and size of the investors the IPO is aiming to attract.

FINLAND

Law and Practice

Contributed by:
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Waselius is a commercial law firm based in Helsinki, committed to providing highly specialised legal services within the fields of M&A, capital markets, banking and finance, financial regulation, dispute resolution, IP rights, tax law, employment law, and EU and competition law. The private equity practice covers all stages of private equity, from fund formation to investments and exits. The team advises leading international and domestic private-equity houses and their portfolio companies on structuring, negotiating and executing transactions, ranging from small add-ons and divestments to large cross-border buyouts. The firm also offers leading expertise in public M&A, capital markets, leveraged finance and tax. It has extensive experience in assisting clients in challenging domestic and international transactions, including the sale, purchase and financing of companies and businesses, joint ventures, mergers, takeovers, private-equity/venture-capital transactions and management buyouts.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

2022

Deal flow remained strong during the first half of 2022. However, the latter half of 2022 saw soaring inflation and rising interest rates, which led to deal activity declining markedly towards the end of the year.

2023

Finnish M&A transaction volumes reached historically low levels in 2023, with the market slowdown evident across all sectors. The Finnish weekly business magazine, Talouselämä, predicted in October 2023 that the year would finish off with approximately 430 deals, a major decrease of approximately 33% compared to the figures in 2022. In respect of investment activity of private start-up investors, following the record high reached in 2021, private external early-stage investors invested a total of EUR26 million into 173 companies. This was a marked drop of 30% both in volume and value compared to the previous year. In addition, according to statistics published by the Finnish Venture Capital Association, Finnish start-up and growth companies received a total of EUR871 million in investments in 2023, an almost 50% decrease to the record high EUR1.7 billion the year before.

2024 and the Outlook for 2025

2024 has picked up a little speed although still underperforming against 2023. The continuing Russian war of aggression against Ukraine, stubborn inflation, soaring prices and interest rates continue choking global growth and preventing economic growth. Despite stabilising interest rates, the direction M&A deal activity will take for the remainder of the year and the first half of 2025 is difficult to predict. There would seem to be plenty of dry powder available, but the value gap between sellers and buyers remains to be bridged although is beginning to narrow down. High interest rates have also kept leveraged buyers at bay.

1.2 Market Activity and Impact of Macro-Economic Factors

The slowdown of M&A activity in Finland has affected all industries, with industrial and professional services sectors taking the biggest hit. The ongoing global political turbulence and economic uncertainties have markedly slowed down both private and public M&A activity, with no clear outlook for the better.

Examples of significant transactions in Finland in 2023 included the sale of Brown-Forman Finland Oy (owner of Finlandia vodka brand) to Coca-Cola HBC AG, the sale of Havator to BMS Group A/S and Stangeland Gruppen AS and the sale

of Delta Auto to Hedin Automotive Oy. Significant transactions in Finland so far in 2024 have included the sale of Touhula Varhaiskasvatus to AcadeMedia AB and the USD665 million sale of Silo AI to AMD Inc.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Lower Turnover Thresholds Implemented in Finnish Merger Control Rules

At the end of 2022, the turnover thresholds for merger control notifications were significantly lowered due to changes in the Finnish Competition Act. Following the changes, the number of notifications made to the Finnish Competition and Consumer Authority (FCCA) increased approximately 40% in 2023. However, this is considerably less than expected since the FCCA had estimated that the number of notifications would double compared to 2022. The main reason for the relatively low number of notifications was the decline in M&A deal activity in Finland.

The EU Foreign Subsidies Regulation is potentially a significant issue also in Finland. However, so far the entry into force of the FSR has not had any considerable effect on acquisitions of Finnish companies.

Vigilance in the Monitoring of Foreign Corporate Acquisitions

Due to Russian aggression in Ukraine and the COVID-19 pandemic, the Ministry of Economic Affairs and Employment has recently been very vigilant regarding transactions related to national security or security of supply, as well as transactions in the healthcare sector. The Ministry of Economic Affairs and Employment follows public announcements in the media regarding transactions. If a transaction is not notified to the ministry, it may intervene even after the signing or closing of the transaction in cases where the ministry considers it necessary under the Act on the Screening of Foreign Corporate Acquisitions. Despite Finland's positive attitude to foreign investments, it cannot be excluded that the Council of State could use the possibility to prohibit an acquisition if the target company is active in a sector critical for the defence, national security or security of supply.

Finnish Interest Limitation Rules

The Finnish interest limitation rules have had a significant impact on the use of leverage (on both a fund and at holding company level), but also on feeder fund structures using, for example, profit-participating loans.

During the few last years, extensive discussions concerning the taxation of carried interest have also taken place, as the tax authorities previously concluded that carried interest should be taxed as earned income of the manager. However, as a result of current case law, carried interest is now taxed primarily as capital income of the manager, if the arrangement itself does not constitute tax avoidance. Accordingly, the legal form of the structure is normally upheld and carried interest is deemed as a return on investment.

EU Legislation

Furthermore, recent developments at the EU level have introduced legislation with respect to the reporting of cross-border transactions as well as taxation of hybrid transactions. The former provides an obligation to report cross-border transactions that have certain characteristics identified as potentially indicative of aggressive tax planning, and the latter imposes limitations to hybrid arrangements, where the tax treatment of income/expense differs between jurisdictions.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

In general, Finnish M&A transactions are governed by national legislation and EU regulation. The main national legislation includes:

- the Contracts Act (228/1929, as amended);
- the Sale of Goods Act (355/1987, as amended);
- the Companies Act (624/2006, as amended);
- the Employment Contracts Act (55/2001, as amended), relating to the transfer of employees in asset purchases or transfers of undertaking in particular;
- the Competition Act (948/2011, as amended) with respect to merger control and non-compete agreements; and
- the Act on the Screening of Foreign Corporate Acquisitions in Finland (172/2012, as amended), which monitors foreigners' corporate acquisitions in Finland.

In addition, the following regulations should be observed when dealing with publicly listed companies:

- the EU Market Abuse Regulation (596/2014);
- the EU Prospectus Regulation (2017/1129);
- the Securities Market Act (746/2012);
- the Helsinki Takeover Code; and
- the Corporate Governance Code.

The M&A market is not particularly regulated, except in respect of publicly listed companies and the regulation governing transfers of undertakings from an employment law perspective. The key regulator with respect to foreign direct investment is the Ministry of Economic Affairs and Employment and the key regulator with respect to merger control is the Finnish Competition and Consumer Authority.

M&A transactions are subject to merger control under the Competition Act. An M&A transaction, or a concentration for the purposes of the Competition Act, is subject to control if both the combined turnover of the parties to the concentration generated in Finland exceeds EUR100 million and the turnover generated in Finland of each of at least two parties to the concentration exceeds EUR10 million.

The EU Foreign Subsidies Regulation regime is fully applicable in Finland. In that respect, the competent authority is the European Commission.

Monitoring of Acquisitions by Foreign Buyers

Under the Act on the Screening of Foreign Corporate Acquisitions, a foreign buyer must apply for prior approval from the Ministry of Economic Affairs and Employment for an acquisition that would result in it holding more than one tenth, one third or one half of the voting rights (or corresponding actual influence) of a Finnish defence or security company. In addition, a foreign buyer may submit a notification to the Ministry of Economic Affairs and Employment for an acquisition resulting in the buyer holding more than one tenth, one third, or one half of the voting rights (or corresponding actual influence) of a company or business holding a key position with respect to maintaining vital functions of Finnish society.

A "foreign buyer" is defined as (i) a person, organisation or foundation not domiciled in an EU or EFTA (European Free Trade Association) member state; or (ii) any organisation or foundation domiciled within an EU or EFTA member state in which a foreigner or entity referred to above in (i) holds at least one tenth of the voting

rights in the case of a limited liability company, or corresponding actual influence in the case of another entity or business. In case of Finnish defence companies, the definition of a foreign buyer also includes entities domiciled in an EU or EFTA member state (other than Finland).

Approving Acquisitions

The Ministry of Economic Affairs and Employment approves acquisitions resulting in the control of these companies, unless the acquisition endangers key national interests, in which case, the matter is referred for consideration to the Council of State. The Council of State may either approve the acquisition or, if necessary due to a key national interest, refuse to approve it. Such interests include:

- military national defence;
- national security and public order; and
- functions vital to society (including safeguarding critical infrastructure and security of supply).

The Ministry of Economic Affairs and Employment may impose conditions on an acquisition if it is necessary to secure key national interests. The conditions must be accepted by the parties to the acquisition.

If approval is not granted, the buyer must decrease its ownership to less than one tenth (or less than one third or one half) of the shares in the company, and can only exercise the corresponding voting rights at a general meeting of the company's shareholders or other relevant corporate body.

Anti-bribery, Sanctions and ESG Compliance

According to the Finnish Criminal Code (39/1889, as amended), giving or accepting a bribe in business is a felony and subject to a fine or imprisonment. This applies to a person in the service of a business, a member of the administrative board or board of directors, managing director, auditor, receiver of a corporation or a foundation engaged in business, a person carrying out a duty on behalf of a business, or a person serving as an arbitrator and considering a dispute between businesses, between two other parties, or between a business and another party. There is no separate legislation or guidance relating to anti-bribery in Finland in addition to the Criminal Code. No changes in the approach to anti-bribery issues have taken place in 2023–2024.

The national general regulation regarding the implementation of UN/EU sanctions is the Act on the Fulfilment of Certain Obligations of Finland as a Member of the United Nations and of the European Union (659/1967). The sanctions imposed by the EU must be fully complied with in Finland. As the EU sanction regulations continue to be amended regarding Russia and Belarus, companies must observe the quickly changing lists in their actions, including M&A transactions. Further, the National Bureau of Investigation publishes national freezing orders in the Official Journal of Finland (so-called NBI freezing list). National freezing orders refer to decisions imposed under the Act on the Freezing of Funds with a View to Combating Terrorism (325/2013, as amended).

According to the Accounting Act (1336/1997, as amended), nationally implementing the Corporate Sustainability Reporting Directive (EU 2022/2464, the CSRD) that entered into force on 5 January 2023, certain large and listed companies (except listed micro-enterprises) must disclose in their annual financial statements how they manage environmental, social and corporate governance related matters according to European Sustainability Reporting Standards

(ESRS). The Accounting Act also includes a reference to EU Taxonomy Regulation (2020/852), which imposes a duty to include specific information regarding sustainability in these statements. The CSRD expanded the scope of companies subject to mandatory disclosures as well as strengthened the rules on reporting social and environmental information. The new rules will need to be applied for the first time to reports concerning the financial year 2024.

4. Due Diligence

4.1 General Information

Scope and Areas of Focus

Legal due diligence is usually conducted on an issues-only/red-flag basis. It is increasingly rare to obtain detailed reports, even in insured transactions – ie, where a warranty and indemnity insurance policy is obtained. The applicable materiality threshold and scope of the due diligence depend on, among other matters, industry-specific aspects and the size of the target, as well as whether or not the transaction is insured. The key areas of focus are usually agreed separately between the buyer and the legal adviser, and typically cover areas such as corporate documentation, commercial agreements, financing, tax (unless there is a separate tax adviser), employment, disputes, regulatory aspects, real estate, environment, data protection and privacy, as well as intellectual property rights.

Procedures

From a procedural point of view, due diligence reviews are typically conducted by the relevant professional advisers (eg, legal, financial, tax, and business or technical advisers) as a combination of document reviews and Q&A sessions with the target's management. In addition to the information disclosed by the seller in the data room, the buyer takes advantage of the relevant information available in public databases (such as the articles of association, the annual accounts and other trade register information regarding the target).

Data Room

As a rule, the due diligence material is usually provided through a virtual data room, and it is increasingly common for the data room to be split into a general data room and a clean room, the latter of which includes information that is sensitive from either a business, technical or antitrust point of view.

4.2 Vendor Due Diligence

Vendor due diligence constitutes more or less common practice in transactions involving private equity sellers. The vendor due diligence report or fact book is typically given on a non-reliance basis to the buyer and its advisers. Hence, separate release and non-reliance letters are typically entered into in connection with the disclosure of the vendor due diligence report.

The buy-side legal adviser typically provides the buyer with reliance on the buy-side legal due diligence report, and, on a less frequent basis, on the buyer's warranty and indemnity insurer or lenders.

5. Structure of Transactions

5.1 Structure of the Acquisition

A privately held company is typically acquired by entering into either a share purchase or an asset purchase agreement, with share purchases being used more often. Buyers may also participate in auction processes arranged by or for the sellers. Auction processes are more common

when the seller has engaged an M&A adviser and the target is likely to attract several purchase candidates.

Typically, there are no material differences between the terms and conditions of a privately negotiated transaction and an auction sale, but the warranties tend to be less extensive in an auction sale than when negotiating with only one potential buyer. That said, when warranty and indemnity insurance is used, the warranty catalogue offered by the sellers tends to be fairly extensive. In an auction sale, the seller usually prepares the first draft of the agreement. "Stapled" warranty and indemnity insurance is increasingly being used in auction processes, whereby a seller-nominated insurance broker pre-packages an indemnity and warranty insurance policy that the buyer is expected to sign.

Public tender offers are used in takeover bids made by private equity funds.

5.2 Structure of the Buyer

The private-equity-backed buyer is typically structured through one or more SPVs, which are domestic or foreign limited liability companies, while the private equity fund would, for instance, be directly involved in the equity commitment letter, if any. The structures of the transaction and the buyer are typically influenced by tax considerations.

5.3 Funding Structure of Private Equity Transactions

Private equity deals are commonly financed through a combination of debt and equity financing, in line with international practices. Equity commitment letters as well as commitment letters from banks are commonly used to provide contractual certainty of funds, particularly in deals involving international sponsors. In highly competitive transactions with high-value targets, funds requirements can go further and fully executed loan documentation may be required for submitting a valid bid. Equity and debt funds are typically committed at the signing stage of the transaction.

In most private equity deals, the private equity fund buys a majority stake in the target, but there are of course private equity funds whose strategy is to acquire minority stakes only.

5.4 Multiple Investors

Consortiums are common where the value of the target is high, and also where the industry sector of the target makes consortiums more useful, such as infrastructure assets where having (in particular, domestic) pension funds in the consortium may increase the chances of a winning bid and also assist with public relations issues. Consortiums are quite rare in smaller and mid-sized deals. Co-investors are usually more passive than a general partner, but media coverage critical of private-equity-backed companies, particularly in the healthcare sector, has caused co-investors to enforce their corporate social responsibility policies more strongly in companies in which they have invested.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Completion Accounts and Locked-Box Structures

Both completion accounts and locked-box consideration structures are used in Finland, depending on the type of transaction and the parties involved. Fixed price deals without locked-box structure are rarely seen. Locked-box structures became increasingly common

during the last few years; however, the use of completion accounts has increased lately due to the recent economic uncertainty.

Usually, the seller prefers the locked-box structure to completion accounts, which tend to be more popular on the buyer side, especially in transactions that do not involve private equity investors. In a locked-box structure, the buyer usually requires that the seller covenants that the target operates its business in the ordinary course and that there is no leakage, ie, that the target does not pay any dividends or make other distributions to the seller between the locked-box date and closing (such distribution being known as "leakage").

Earn-Out Structures

Earn-out structures are used to a lesser extent, but they do occur in particular in smaller transactions to bridge a potential gap in the valuations of the seller and the buyer. However, the use of earn-out structures is rather limited due to the challenges relating to the operation of the target during the earn-out period and the fact that it may be difficult for the parties to reach consensus with respect to the earn-out calculation mechanisms. Earn-out structures were expected to become more prevalent due to the COVID-19 crisis but no significant changes have, so far, been seen.

Deferred or Additional Purchase Price Mechanisms

Deferred or additional purchase price mechanisms are also sometimes used and are often conditioned to the occurrence of a future event agreed between the parties.

Roll-Over Structures

Roll-over structures are seen from time to time, albeit rarely, since there is no specific roll-over tax relief in Finland. Therefore, any reinvestment by management would be made with after-tax proceeds.

Compensation

For the purpose of compensating the seller for the target's anticipated cash flow during the period between the locked-box date and completion, it is common for the locked-box price to be subject to an interest mechanism, which is typically calculated from the relevant locked-box date until completion.

6.2 Locked-Box Consideration Structures

It is not very common for interest or reverse interest to be charged on a leakage that occurs during a locked-box period.

6.3 Dispute Resolution for Consideration Structures

Locked-box consideration structures do not usually have specific dispute resolution mechanisms. In deals with completion accounts, it is almost a rule that there is a specific dispute resolution mechanism under which a dispute with respect to the completion accounts may be referred by either party for determination by an independent auditor. At the outset, either the locked-box or completion accounts consideration structure is also subject to a general dispute resolution provision under the share purchase or asset purchase agreement, which often refers to arbitration proceedings as agreed between the parties.

6.4 Conditionality in Acquisition Documentation

The level of conditionality in private equity transactions depends on the target characteristics and the industry in which the target is involved, among other matters. Save for regulatory condi-

tions, such as relevant competition law approvals, approval under the Act on the Screening of Foreign Corporate Acquisitions or clearances under the EU Foreign Subsidies Regulation (Regulation (EU) 2022/2560), other completion conditions have rarely been included during the last few years with high deal activity. However, completion conditions are still included in deals where the specifics of the case call for them, for instance, necessary third-party consents from key contractual counterparties or relevant finance providers of the target due to change of control provisions.

Material adverse change/effect provisions are uncommon in the Finnish market.

6.5 "Hell or High Water" Undertakings

In highly competitive deals, private-equity-backed buyers do occasionally accept "hell or high water" undertakings. While such undertakings are not the norm in Finnish transactions, they have been used or accepted more frequently during the last few years of heightened competition for attractive targets. No distinction is typically made between merger control and foreign investment conditions for the purposes of such undertakings.

6.6 Break Fees

Break fees are rarely used in the Finnish market but they do appear from time to time, mainly in highly competitive auctions, for instance, in relation to breaches of "hell or high water" undertakings. With respect to public takeover bids, the Helsinki Takeover Code provides that a break fee (or reverse break fee) may be justifiable in some situations if:

- the acceptance of the arrangement and receiving the bid is, in the opinion of the board of directors of the target company, in the interests of the shareholders; and
- the amount of the break fee is reasonable, taking into consideration the costs incurred by the offeror in preparing the bid, among other things.

A break fee to be paid by the target company due to a reason arising from the offeror is, however, not deemed justifiable.

6.7 Termination Rights in Acquisition Documentation

The acquisition agreement usually provides very limited possibilities for either party to terminate the agreement. Such termination rights often relate to unsatisfied conditions precedent and/or other closing conditions, such as a party's failure to fulfil a closing condition by an agreed date. However, termination of the acquisition agreement is usually not automatic in the sense that the parties typically undertake to negotiate a new closing date, if relevant. A typical long-stop date is usually a few months from the initially planned closing date, and in most cases conditional on pending merger control/foreign investment processes.

6.8 Allocation of Risk

Warranty and Indemnity Insurance

It is common for private equity sellers to use warranty and indemnity (W&I) insurance and thereby exclude their liability under the seller's warranties. However, customary exclusions from the W&I insurance coverage include, for instance, warranty breaches caused by intentional misconduct, fraud or known risks, as well as forward-looking statements, criminal liability and environmental liability, plus certain tax liability. In addition, unless separate new breach coverage has been obtained, warranty breaches that have occurred and become known in the interim

period between signing and closing are usually excluded from the W&I insurance coverage.

Limitation of Liability Due to Gross Negligence

Whether a seller is able to limit its liability in a case of damage caused due to gross negligence (in addition to fraud and intentional misconduct), remains questionable under Finnish law. Based on their goal to distribute the sales proceeds to investors sooner rather than later, private equity sellers seek to limit the time in which a buyer is able to make a claim to a shorter period than in deals where the seller is not a fund.

Transfer of Risk

Buyer's liability

At the outset, the parties are free to agree on the allocation of risk between themselves. With respect to risks identified by the buyer during the due diligence phase, the buyer should seek a specific indemnity, as a buyer is generally not able to make a claim for a breach of warranty if the buyer knew of the breach before entering into the agreement. In an asset deal, only the identified liabilities of the target will transfer from the seller to the buyer (except for certain potential unidentified liabilities, such as liability for environmental damage, which may transfer to the buyer under mandatory law). In a share deal, on the other hand, all prior liabilities of the target will automatically transfer from the seller to the buyer at the outset.

Seller's liability

The seller's liability is typically limited to breach of warranties, conditions and covenants under the acquisition agreement.

6.9 Warranty and Indemnity Protection

As W&I insurance has become more common, deals with very limited warranties or fundamental warranties only are increasingly rare; warranties given by the management team only are less frequent for the same reason.

Typically, the warranties given cover the following main areas:

- fundamental warranties, eg, corporate organisational matters and ownership of shares (or assets, in an asset deal);
- financial matters, including correctness of the accounts;
- agreements;
- employees and employee benefits;
- intellectual property rights;
- litigation;
- compliance with laws and permits;
- tax;
- real estate; and
- environmental matters.

Typically, the seller strives to limit warranties other than the fundamental warranties (eg, ownership of shares in a share sale) in various ways. Such limitations may be structured in the following ways:

- qualifying warranties by the seller's knowledge so that the buyer assumes the risk for unknown breaches of warranties (less so in insured transactions);
- materiality qualifiers excluding the seller's liability for minor breaches in the form of monetary de minimis and basket caps; or
- time limitations for the indemnity obligation (or a specific survival period for warranties, but the former is preferable).

"Fair Disclosure"

Regarding disclosure, it is market practice in Finland that a buyer's right to make a claim under the acquisition agreement is limited by informa-

tion that has been "fairly disclosed", meaning that the buyer's ability to present a claim against the seller for a warranty breach is limited to the matters or risk not sufficiently disclosed in the data room (or in other disclosure material).

Time Limit

The time limit for presenting a claim usually varies between 12 and 24 months, with longer periods for presenting claims under fundamental warranties as well as tax and environmental warranties. The maximum liability of the seller is typically somewhere between 10% and 30% of the enterprise value. As a general rule, the larger the enterprise value, the lower the percentage. The basket cap is typically approximately 1% of the enterprise value, and the monetary de minimis cap is typically approximately 0.1% of the enterprise value. In deals where the enterprise value is based on high EBITDA multipliers, the de minimis caps are often adjusted downwards as the typical cap of 0.1% of the enterprise value could effectively bar relevant claims based on warranty breaches.

6.10 Other Protections in Acquisition Documentation

The acquisition agreement may include certain specific indemnity undertakings by the seller for certain risks identified by the buyer or disclosed by the seller during the due diligence phase.

It has become increasingly common for the parties to take out W&I insurance in order to provide cover for losses arising out of warranty breaches. Therefore, it is more common for the private equity seller to give the warranties (as opposed to warranties given only by the management), while the W&I insurer is liable to compensate under the policy. W&I insurance typically covers both fundamental and business warranties, with tax warranties covered from time to time.

A more recent development in the W&I insurance space is the occurrence of so-called "synthetic" warranty and indemnity insurance. For synthetic W&I insurance, the warranties are not given by the seller and, instead, a synthetic set of warranties is attached to the insurance policy. The wording of the warranties is therefore not dependent on negotiations between the seller and the buyer, but, assuming that it is a buy-side policy, between the buyer and the insurer.

Escrow or holdback arrangements, on the other hand, are unusual in deals with private equity sellers.

6.11 Commonly Litigated Provisions

Litigation relating to M&A transactions in general and, specifically, private equity transactions is uncommon in Finland, and disputes are usually settled prior to proceeding to arbitration. Provisions that tend to be most commonly litigated include purchase price mechanisms, warranty breaches, possible additional purchase prices (such as earn-out) and breach of non-compete provisions. Buyers are likely to be less reluctant to make claims against W&I insurers than against a portfolio company's management.

7. Takeovers

7.1 Public-to-Private

Public-to-private transactions have become more common in recent years, with notable high-profile deals taking place in 2024, such as:

- the cash tender offer by Apollo-led consortium Project Grand Bidco (UK) Limited for all shares in Purmo Group Plc and the cash tender offer by Matrix 42 for all shares in Efecte Plc;

- in 2022–2023, the cash tender offer by Crayfish BidCo Oy for all shares in Caverion Plc, the cash tender offer by Sega Europe Limited for all shares in Rovio Entertainment Plc and the cash tender offer by Georg Fischer AG for all shares in Uponor Plc;
- in 2021–2022, the cash tender offer by Sapphire BidCo Oy for all shares in Basware Plc;
- in 2020–2021, the cash tender offer by PPG Industries, Inc for all shares in Tikkurila Plc;
- in 2019–2020, the cash tender offer by Telenor for all shares in DNA Plc; and
- in 2018–2019, the cash tender offer by Mehiläinen Yhtiöt Oy for all shares in Pihlajalinna Plc.

In one of the largest Finnish public-to-private transactions to date, Blackstone Group made a tender offer in 2017–2018 and acquired Finnish real estate investment company Sponda Oyj, with an enterprise value of EUR3.8 billion. Another notable transaction was CGI Group's bid in 2017 for Affecto, one of the biggest providers of business intelligence and enterprise information management solutions.

In 2018–2019 a consortium led by Chinese sportswear company Anta Sports made an offer to acquire Finland's Amer Sports in a deal that valued the target company at EUR4.6 billion.

The role and actions/duties of the target company's board of directors in a takeover is regulated in the Helsinki Takeover Code. If the board of directors considers the approach by a bidder to be of a serious nature, it shall swiftly examine the matter, evaluate the proposed bid and acquire sufficient and appropriate information to support its evaluation. The board of directors of the target company is at all times obliged to promote the interests of all shareholders of the target company and must seek the best outcome for the shareholders.

In a friendly takeover, the bidder and target company typically enter into a combination or transaction agreement in which the main terms of the offer and co-operation of the parties are agreed upon.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Shareholders or persons comparable to shareholders must notify the listed company and the Finnish Financial Supervisory Authority (FFSA) of changes in shareholdings when the holding and/or the holdings of controlled entities exceed, fall below or reach the notification thresholds of 5%, 10%, 15%, 20%, 25%, 30%, 50%, 2/3 or 90% of the number of voting rights or shares in the company. The notification must be made in writing without undue delay, and no later than the next trading day after the shareholder has learnt or should have learnt about the transaction triggering the notification obligation.

An obligation to disclose major holdings may arise on the grounds of existing proportions of holdings and voting rights, or on the acquisition of a so-called long-position through financial instruments, or any combination of the above. The notification obligation may also arise without any specific measures being taken by the shareholder if, for example, shareholdings are diluted due to an increase in the number of shares as a result of a share issue, or a proportional holdings increase due to the annulment of the target company's own shares.

A company whose securities are traded on the Helsinki Stock Exchange is required to disclose regulated information in a manner that ensures fast access to such information on a non-dis-

criminatory basis. The issuer must ensure the dissemination of information to the media so as to ensure that the information is published as extensively as possible in the home country and throughout Europe, where applicable.

7.3 Mandatory Offer Thresholds

The Securities Markets Act provides for mandatory offer thresholds. A mandatory offer for all shares of the target company must be made if a shareholder acquires a stake that exceeds 30% or 50% of the votes in the target company. The mandatory offer must be launched no later than one month after the date on which the mandatory offer threshold was reached, unless an exemption from the mandatory offer obligation exists. There is no obligation to launch a mandatory offer if the relevant threshold has been reached by means of a voluntary offer for all shares of the target company.

When determining the size of the holding for the purposes of the mandatory offer obligation, the voting rights held by the shareholder are aggregated together with voting rights held by related parties of the shareholder and parties deemed to be acting in concert with the shareholder (eg, on the basis of an agreement or otherwise).

7.4 Consideration

Cash consideration is usually preferred by Finnish shareholders and is the most common form of consideration in takeovers. Shares in the buyer, or a combination of shares and cash, are occasionally used as consideration, but may give rise to additional regulatory requirements, such as the preparation of an information document or prospectus.

A general principle under the Securities Markets Act is that all shareholders of the target must be treated equally, meaning that the same consideration must be offered to all shareholders.

With respect to pricing of a voluntary offer, it is generally at the offeror's discretion. However, where the offer is made for all shares and securities entitling to shares, the offer price shall be the highest price paid by the offeror (or a related party or person acting in concert with the bidder) during the six months preceding the announcement of the offer. Where the offeror has not made such purchases, no minimum pricing rule is applied.

In mandatory offers, the consideration offered must be at the least the highest price paid by the bidder (or a related party or person acting in concert with the bidder) for the securities during the six months preceding the commencement of the obligation to bid by the bidder.

The bidder may be subject to a top-up and compensation obligation in certain instances.

7.5 Conditions in Takeovers

A voluntary takeover offer may include offer conditions. With the exception of mandatory takeover bids, there is no specific legal regulation of the content of the conditions set on the completion of prospective bids, nor on the kind of conditions that are allowed on completion of voluntary public takeover bids. A mandatory takeover bid may be conditional only to the extent that necessary regulatory approvals are obtained.

According to the FFSA, the conditions should be sufficiently unambiguous for the holders of the target securities to be able to assess the probability of the fulfilment of the conditions, so that the fulfilment of the conditions is not left to the offeror's discretion. The conditions must also be fair in that shareholders are treated equally, and

the rights and obligations of the offeror are balanced with the rights and obligations of the holders of the target securities. The offeror may not invoke a condition set out for the implementation of the bid unless non-fulfilment of the condition is essential for the contemplated acquisition.

Frequently Used Conditions

Frequently used conditions in voluntary public takeover bids include the condition that the offeror obtains the required authority approvals for the acquisition of the target company, and that the terms and conditions of such approvals are commercially acceptable to the offeror. The completion of the takeover may further be made conditional on the offeror acquiring a certain level of ownership – usually more than 90%, which is the so-called squeeze-out threshold. In certain circumstances, the conditions of the takeover may require a resolution by a general meeting of the target company. The offer may, for example, be conditional on achieving an amendment of the articles of association of the target company before completing the bid.

Disclosure of Financing Arrangements

Prior to making a takeover bid public, the offeror must ensure the availability of the necessary financing. The availability of the finance may be agreed on a conditional basis, such as that no material adverse change takes place on the financing markets or in the target company, or on the takeover bid being completed in accordance with its terms. Conditions and elements of uncertainty relating to the financing arrangements that are essential to the evaluation of a bid must be made public at the time the bid is disclosed.

Additional deal security measures may include, for example, break fees (as discussed in **6.6 Break Fees**) or non-solicitation provisions, if they are considered to be in the interest of the target company.

7.6 Acquiring Less Than 100%

If a bidder obtains more than 90% of the target's shares and votes, the bidder has the right to squeeze out remaining shareholders at a fair price. In such a squeeze-out situation, a minority shareholder is also entitled to require the majority shareholder to redeem their shares. The redemption price is the fair price preceding the initiation of the squeeze-out procedure, and is finally determined in statutory arbitration in the case of dispute.

A majority shareholder's possibility to control a company's board and operations is limited by minority protection provisions such as the right to demand a minimum dividend (being at the outset one half of the profits of the company of the preceding accounting period). A shareholder holding in excess of 33.3% of the shares or votes can prevent all changes to the articles of association and any directed share issuances in deviation from the shareholders' pre-emptive rights, as well as most mergers, de-mergers, share buybacks and other resolutions requiring a two-thirds majority.

The use of holding companies in third-party acquisitions has been widely accepted in Finnish taxation practice, and the prevailing view is that the deductibility of the interest on the acquisition loan generally cannot be denied by applying anti-avoidance rules.

7.7 Irrevocable Commitments

In order for a tender to be successful, obtaining irrevocable commitments from the principal shareholders of the target company may be conclusive and, thus, it is common to aim to ensure the involvement of the principal shareholders

in the tender. Negotiations with shareholders are made before public disclosure of the offer. It should be noted that such shareholders will subsequently usually become subject to regulations on insider trading. The undertakings are usually conditional in that they provide an out for the shareholder if a better competitive offer is made, by reserving the shareholder's right to attend to the competitive offer instead.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentivisation is a fairly common feature of private equity transactions. The level of equity depends on the circumstances at hand, but generally, management is allocated somewhere between 5% and 15% of the ordinary equity. However, this amount may be even higher, especially in smaller deals.

8.2 Management Participation

It is rather common to structure management participation by using sweet equity pots. The equity allocated to management usually consists of either ordinary or preferred shares. Generally, management is allocated somewhere between 5% and 15% of the ordinary equity, but this may be even higher, especially in smaller deals.

8.3 Vesting/Leaver Provisions

Manager shareholders' ownership of shares is usually subject to a vesting period whereby the shares allocated to the management vest over time. If a manager shareholder leaves the company before exit, it is likely that the maximum share of equity allocated to them will not have vested by the time of their departure. A manager shareholder's shares are, further, usually subject to a redemption right, but not obligation, for the private equity fund, the other shareholders and the company.

"Bad leaver" provisions for manager shareholders typically relate to situations where the relevant shareholder has materially breached the shareholder agreement, the company has terminated the manager shareholder's employment or service agreement on personal grounds stipulated under Finnish employment laws, or the manager shareholder has decided to resign from the company. "Good leaver" provisions, on the other hand, typically relate to situations where the manager shareholder's employment or service agreement has ended or been terminated on other grounds, such as due to the death, retirement or disability of the manager shareholder. Vesting provisions usually offer a linear vesting of the management's shares during a period of approximately three to six years from the investment.

In a good leaver situation, the purchase price is usually determined based on the market value of the shares, whereas in a bad leaver situation the purchase price is usually established based on the lower of the original purchase price of the shares (or as a material discount) or market value.

8.4 Restrictions on Manager Shareholders

Restrictive covenants on the manager shareholders (and the rest of the shareholders) are usually included in a shareholder agreement, and typically include provisions on share transfer restrictions and, subject to certain limitations, non-compete and non-solicitation undertakings, among others. Depending on the circumstances at hand, the non-compete and non-solicitation undertakings may become unenforceable if they are deemed unreasonable and extensive.

Non-compete covenants are further usually imposed in the purchase agreement but they may, as a rule, only apply to controlling shareholders. The maximum duration of non-compete covenants that can be considered permissible depends on the circumstances. Usually, they are considered justified for periods of up to three years if the acquisition includes transfer of goodwill and customer base as well as know-how. If know-how is not included, non-compete undertakings are, generally, justified for periods of up to two years.

In employment or service agreements entered into with management members, it has generally been deemed permissible to include non-compete and non-solicitation undertakings for the term of the agreement and a maximum period of 12 months after the expiry of the agreement. A non-compete obligation requires a particularly weighty reason related to the employer's operations or the employment relationship. A non-compete undertaking does not bind the employee if the employment is terminated for a reason attributable to the company, for instance, if the company has terminated the employment due to financial or production-related reasons or for reasons arising from reorganisation of the company's operations.

Rules on Compensation Payable to the Employee

The rules governing the use of non-competition clauses in employment agreements changed as of 1 January 2022, and these apply to all agreements as of 1 January 2023 even if the non-competition clause was concluded before 1 January 2022. Under the current rules, an employee is always entitled to compensation for a non-compete obligation that remains in force after the termination of the employment. The monthly compensation to be paid during the term of the non-compete obligation is equal to 40% of the employee's monthly salary if the duration of the non-compete obligation is six months or less, and 60% of the employee's monthly salary if the duration of the non-compete obligation exceeds six months. Under the current rules, the employer must observe a notice period before the employer may terminate the non-compete clause included in the employment agreement. The applicable notice period is two months if the term of the non-compete obligation is six months or less, and equal to a third of the term of the non-compete obligation if the term exceeds six months. Furthermore, the company may not unilaterally terminate the non-compete clause after an employee has terminated their employment.

8.5 Minority Protection for Manager Shareholders

Manager shareholders may, depending on the size of their shareholdings, enjoy certain minority protection rights in relation to the decision-making of the company and the right to demand a minimum dividend (being at the outset one half of the profits of the company of the preceding accounting period), among others. Those provisions apply to all limited liability companies, but the shareholders usually agree to deviate from the minority shareholder rights in the shareholder agreement to the extent this is enforceable under law. Private equity investors often require the shareholder agreement to include certain anti-dilution provisions in order to secure their equity share but these are less common for manager shareholders. Veto and control rights, as well as rights of control over exit, are usually held by the private equity investors.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

Typically, provisions on shareholder control are included in a shareholder agreement between the shareholders of the target. Such provisions typically include, for example:

- the right to appoint a certain number of board members (including the chairperson) and the managing director;
- control over the exit;
- veto rights in relation to the commencement of litigation proceedings;
- the execution of new share issuances; and
- other financing arrangements of the target, among other matters.

9.2 Shareholder Liability

At the outset, Finnish law does not impose any shareholder liability for the actions of the portfolio company and thus far the corporate veil has only been pierced in exceptional circumstances.

10. Exits

10.1 Types of Exit

The typical holding period for private equity transactions before the investment is sold or disposed of is around five to ten years. Dual-track processes have become increasingly popular in recent years, and are sometimes even run in parallel during the whole process. 2021 saw record-breaking activity in relation to the number of IPOs in Finland, with eg, Kreate Group, Orthex Group, Sitowise Group, Puuilo and Virala Acquisition Company (the first Finnish SPAC) entering the main list. However, Finnish IPO activity slowed down markedly in 2022 since record activity in 2021, with the number of IPOs halved in 2022 compared to 2021. The IPO market all but stopped in 2023, with only two entrants to the main list of Nasdaq Helsinki (spin-off of Mandatum Plc from Sampo Plc and the technical listing of Lamor Corporation Plc from First North) – the lowest in ten years.

Generally, most dual-track processes have resulted in trade sales in recent years, and trade sales can also be considered the most common form of private equity exit, but the increased IPO activity in 2021 led to many IPO exits for private equity investors. Private equity sellers occasionally reinvest upon exit, while it is customary for private equity sellers to remain as investors for brief lock-up periods after IPOs.

Apart from private sales to other private-equity-backed investors or corporates and IPOs, any other forms of private equity exit have recently been uncommon. Triple-track exit processes where a recapitalisation is prepared in parallel are not common in Finland.

10.2 Drag and Tag Rights

Drag rights are typically included in a shareholder agreement entered into between the shareholders of the target in connection with the transaction. Typically, this would entail a shareholder being contractually forced to sell – eg, upon the occurrence of a triggering event such as the sale of the target – on substantially the same terms and conditions as the other shareholders of the target. Private equity sellers usually decide on the exit under the shareholder agreement and, as private equity sellers commonly have drag rights, they may indirectly utilise the rights even if they do not formally exercise them.

Tag rights are typically included in a shareholder agreement entered into between the shareholders of the target in connection with the trans-

action. Typically, this would entail a majority shareholder who is selling their shares being contractually forced to offer the remaining shareholders the possibility to also sell their shares in the target, on substantially the same terms and conditions as the majority shareholder.

10.3 IPO

The typical lock-up term for a private equity fund is 180 days. Relationship agreements between the private equity seller and the target company are rarely seen in the Finnish market.

FRANCE

Law and Practice

Contributed by:
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Valther Avocats is an independent law firm based in Paris which operates in all areas of business law (M&A/private equity, commercial litigation, restructuring, employment law and tax law). Its main activity is in the field of mergers and acquisitions and private equity transactions. Valther assists its clients in all aspects of these transactions, from the performance of due diligence to post-closing monitoring and the implementation of contractual documentation. The team at Valther is composed of 20 professionals, including five partners and 20 associates and lawyers, all of whom are dedicated to the satisfaction of the firm's clients and to the completion of the assignments entrusted to them. Valther offers a personal touch and more flexible service than some of the larger English and American law firms, and this allows the firm to provide a wide range of expertise at a fair price while maintaining proximity and responsiveness to its clients.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

Recent Trends

The recent trends in private equity transactions and M&A deals more generally in France in 2024 are outlined below.

An upturn in deal value

After a significant downturn in 2023, the M&A market in France reached USD82 billion in the first half of 2024, representing a 26% increase compared to the value recorded during the same period last year.

An increase in domestic and inbound deals

In the first quarter of 2024, French domestic transactions increased by 24% compared to the value recorded during the same period last year, reaching USD10.9 billion, while inbound transactions more than doubled, reaching USD6.5 billion. Consequently, with USD17.4 billion in transactions involving a French target, France becomes the seventh most targeted country in the world in 2024.

A maintained increase in outbound deals

French companies continued their trend to acquire businesses abroad. Outbound deals have seen the largest increase this year, rising by 114% compared to the first quarter of 2023 and reaching USD18.9 billion, the highest level recorded since 2018. This trend is being driven by the search for growth opportunities and the desire to gain access to new markets.

A focus on strategic sectors

Private equity firms and strategic acquirers are increasingly focused on investing in strategic sectors, such as healthcare, technology, and consumer goods. These sectors are seen as being more resilient to economic downturns and offer the potential for long-term growth.

2024 Outlook

Overall, the outlook for private equity transactions and M&A deals in France in 2024 is optimistic considering the latest figures. The focus on strategic sectors is also encouraging, as it suggests that investors are looking for businesses with long-term growth potential. Nevertheless, several factors should be considered to adopt a more cautious approach, including the persistence of high interest rates and the potential impact of political uncertainty stemming from France's recent snap election on investor sentiment.

1.2 Market Activity and Impact of Macro-Economic Factors

French companies are entering the M&A market with the aim of reorganising their asset portfolios and positioning themselves for economic recovery and profound change in the industrial environment.

The transactions that are currently supporting the M&A market consist of companies acquiring differentiating assets, providing short-term competitiveness and transforming their business model in depth.

These are complementary investments consisting of the acquisition of specific abilities. French companies want to focus on strengthening their digital and technological capabilities, in the context of increasing digitalisation of the business.

Innovative start-ups, offering buyers new technologies, are interesting cross-sector targets. Indeed, they enable companies to broaden their product or service offerings, to increase their production capacity and strengthen their

resilience. They are now, therefore, first-choice targets.

This means that digital and technological assets have enabled valuation growth for the companies that own them.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

One of the major changes that the regulations governing M&A transactions have undergone over the last four years concerns the control of foreign investments in France. Indeed, an investment made by a foreign natural or legal person may, if it meets certain criteria of sector and ownership of the target, be subject to prior authorisation by the Minister of the Economy and Finance.

Several protectionist measures have broadened the scope of application of this control mechanism. Thus, a decree and an order dated 31 December 2019 supplementing the PACTE law have strengthened this control mechanism.

This control is also reinforced at the European level with the adoption in March 2019 of the regulation on the screening of foreign investments.

Extension of Investment's Control

The sectors that are subject to such control have continued to grow and mainly concern so-called sensitive activities. The decree gives concrete expression to this notion by specifying the following sectors: aerospace and data hosting, the press, food safety, quantum technologies, energy storage, biotechnologies, etc.

A decree and an order dated 28 December 2023 once again strengthen the control system as it is extended to takeovers of French branches of foreign entities and the list of sensitive activities is updated to notably include the processing and extraction of critical raw materials.

Similarly, the thresholds for triggering the control system have been lowered to 10% for publicly traded companies, initially introduced as a temporary measure, are now permanent.

Taking This Control into Account in M&A Transactions

As the decree dated 31 December 2019 introduced the concept of "chain of control", the presence of a foreign investor is sufficient to trigger control even if the direct investor is actually a French-owned entity.

This is an important consideration for all transactions in which a foreign entity is present, which is peculiar to transactions in which investment funds intervene.

The role of legal due diligence has now increased and this investment control must be integrated into the negotiation process between the different actors of the transaction.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

In France, the French Anti-Corruption Agency (*Agence Française Anticorruption* or AFA) has been regulating the practice of M&A transactions to fight corruption since the law of 9 December 2016. The agency publishes annual guidance to good conduct but no large-scale change in French law can yet be observed in this matter.

Regarding ESG compliance issues, France is in line with the global, including European, line following the resolution adopted by the European parliament in March 2021 promising legislation for due diligence in ESG matters. It is also a question of underlining the role that audit committees must play in monitoring the attention investors pay to ESG standards and to the risk of non-compliance with these issues. Many funds are now specialised in socially responsible investments and are still growing, as players in the French financial community become more aware of issues regarding these non-financial criteria.

Private equity transactions may also undergo review by the following regulatory authorities:

- the French Competition Authority; and/or
- the Minister of the Economy and Finance.

French Competition Authority (FCA)

Transactions outside the retail industry and meeting the following three conditions are subject to a merger control procedure by the French Competition Authority:

- the total global pre-tax turnover of all the companies, groups of legal persons or individuals who are parties to the merger is greater than EUR150 million;
- the total pre-tax turnover generated in France by at least two of the companies, groups of legal persons or individuals concerned is greater than EUR50 million; and
- the transaction is not within the EU's jurisdiction (the above-mentioned thresholds being EUR5 billion and EUR250 million, respectively).

If the aforementioned conditions are met, the intended transaction must be notified to the FCA, which will conduct a prospective analysis of the deal's impact on competition. Following such review, the FCA can approve (with or without conditions) or block the transaction.

On 26 March 2021, the European Commission published guidance on the circumstances under which it would accept requests from national competition authorities within the EU to investigate mergers that do not meet EU or even national jurisdictional tests (in particular, in order to prevent so-called killer acquisitions). The effect of such guidance is likely to generate, in the near future, a notification process – even in the absence of sufficient turnover to meet mandatory filing requirements.

Minister of the Economy and Finance

If the private equity fund is incorporated in a foreign jurisdiction and therefore qualifies as a foreign investor, the transaction may be subject to prior approval by the French Minister of the Economy and Finance.

The minister's compulsory authorisation is required if:

- the target is a French company operating in a business sector deemed strategic (such as national defence, public health, cybersecurity, biotechnologies, etc); and
- the intended transaction implies:
  - (a) the acquisition by a foreign investor of a direct or indirect controlling stake in a French entity;
  - (b) the acquisition by a foreign investor of all or part of a branch of activity of a French company; or
  - (c) the acquisition, directly or indirectly, by a non-EU investor (acting alone or in concert with others) of more than 25% of the voting rights of a French company.

Completion of the intended transaction can be either approved (with or without conditions) or rejected by the Minister of the Economy and Finance.

4. Due Diligence

4.1 General Information

The scope and depth of due diligence reviews are determined on a case-by-case basis and therefore vary from deal to deal. In particular, the level of legal due diligence depends on factors such as the scale of the intended transaction, the kind of business run by the target company, the estimated risk level, etc.

In order to identify the potential negative impacts of the transaction on the target's business, buyers are advised to perform due diligence investigations covering as many areas as possible (these may, for instance, include corporate documentation, financial statements, commercial contracts, ongoing litigation, taxation, insurance, etc).

During the due diligence process, confidential documents are usually exchanged through a virtual data room and the parties involved are often required to sign confidentiality agreements.

4.2 Vendor Due Diligence

Vendor due diligence is typically used in the context of a competitive auction process, in order to simplify and accelerate the transaction. More specifically, bidders may rely on the vendor due diligence report when drafting their initial offers.

In general, vendor due diligence reports are deemed to be reliable, because they are elaborated by an independent third party and not by the seller itself. However, arranging further buy-side due diligence in order to confirm the results presented in the sell-side due diligence report is always good practice and is quite customary.

5. Structure of Transactions

5.1 Structure of the Acquisition

In France, most acquisitions by private equity funds are negotiated confidentially. If the negotiations between the seller and the buyer succeed, both parties may then enter into a share sale and purchase agreement (SPA), which is the most typical acquisition scheme in France.

The terms of the SPA may vary slightly, depending on whether the target is sold by means of an auction process or through one-on-one negotiations. In the first case, one can expect the SPA to be more seller-friendly, since in a competitive process, the seller has greater negotiation power.

5.2 Structure of the Buyer

Private equity funds often invest through a special-purpose vehicle (SPV), which is an entity created for the purpose of carrying out a specific transaction.

Most SPVs are incorporated as a simplified joint-stock company (*société par actions simplifiée* or SAS). This corporate form is preferred by private equity investors for various reasons:

- an SAS can be formed with a single shareholder and the capital requirements are very low (an SAS can be incorporated with an initial share capital of EUR1);
- with no strict regulations, the SAS allows for great flexibility in terms of corporate governance, which is particularly appealing for private equity investors; and

- the shareholders' liability is limited to the amount of their contributions.

In general, the acquisition documentation is signed by the SPV (which is a subsidiary of the private equity fund), rather than by the private equity fund itself.

5.3 Funding Structure of Private Equity Transactions

Private equity deals are financed either with cash, debt or a combination of both. The large majority of deals negotiated during the first half of 2022 were at least partly financed with debt.

The structure of the debt can be particularly complex, although its purpose is almost always to finance the acquisition and refinance existing debt. In general, it may consist of:

- senior debt, often granted for a term of five to seven years, comprising several tranches with distinct maturities;
- junior debt, the repayment of which is subordinated to the repayment of the senior debt; and
- mezzanine debt, often granted by specialised investment funds and structured in the form of securities giving access to the target's capital.

To contractually ensure the existence of funds from a privately funded buyer, an equity commitment letter is often used.

Private equity investors usually take both minority and majority positions. However, there has been a real increase in transactions in which investment funds take minority positions. These transactions are no longer the exclusive privilege of small companies, but also concern large medium-sized companies. Similarly, some large investment funds are more willing to take minority positions in order to gain access to more satisfying opportunities, in the context of a managers' buyout or the acquisition of a minority stake in a family business.

5.4 Multiple Investors

With the development of public investment funds, such as the European Investment Bank at the European level or the Public Investment Bank at the French level, it is essential to note that co-investment strategies are increasingly common.

The implementation of such strategies can be explained by the desire not to neglect any growth potential. For example, co-investment is often used to invest in start-ups or in developing companies. These co-investment strategies are implemented in particular with venture capital funds, in the context of projects that target innovation-oriented companies in the science, information and communication technology, infrastructure and renewable energy sectors.

Family offices often invest alongside private equity or venture capital firms on smaller deals, as some of the family members of such family offices are also sometimes limited partners of the private equity fund.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Locked-box and completion accounts are by far the most common forms of consideration structure in France.

The earn-out clause is also quite popular in the French jurisdiction. Although this clause is

inserted in a minority of all private equity transactions, this clause appears in a good proportion of deals overall.

It goes without saying that the COVID-19 crisis has accelerated the resurgence of the earn-out and completion accounts mechanisms, as buyers wish to share the risks related to their acquisition with the sellers.

Regarding the earn-out clause, the COVID-19 crisis is not the only explanation for its progression: the sellers may also see it as an opportunity to reap the benefits of developments or support that will continue after the deal.

Nonetheless, it is evident that the earn-out clause is more prevalent in transactions under EUR100 million. Above these amounts, the parties involved tend to prefer a price that is definitively fixed at the time of closing (usually, by using a locked-box mechanism) without any subsequent contingencies.

6.2 Locked-Box Consideration Structures

When a locked-box mechanism is used, there is typically no interest on the leakage and the adjustment is made on a euro basis.

6.3 Dispute Resolution for Consideration Structures

Both the locked-box mechanism and the completion accounts mechanism can lead to an adjustment of the purchase price post-closing, in the event of leakage (in the first case) or if the target's assets and liabilities have changed (in the second case). But litigations are far more common with the use of the completion accounts mechanism.

In the event of persistent disagreement between the buyer and the seller concerning the purchase price adjustment, it is standard practice to include an expert determination clause in the share purchase agreement, as a resolution mechanism. Pursuant to this, either the buyer or the seller may request the commercial courts to appoint an independent expert.

Following the expert's appointment by the judge, the expert will determine the amount of the price adjustment, which will be binding on both parties (except where a serious error has been committed).

6.4 Conditionality in Acquisition Documentation

Conditions Precedent Commonly Used

Most private equity deals are conditional upon the fulfilment or waiver of certain conditions precedent.

Such conditions precedent generally include:

- obtainment of regulatory approvals (in particular, foreign investment and antitrust approvals);
- obtainment of funding (if any);
- obtainment of third-party consents (if key contracts containing change-of-control provisions were identified during the due diligence process); and
- the absence of any material adverse change (MAC) between signing and closing (if the share purchase agreement contains a MAC clause).

It should be noted that although the use of MAC clauses has increased due to the COVID-19 pandemic, they are not a predominant feature in French private equity deals.

"Hamon" Law

In addition, the so-called Hamon law has imposed several other conditions that must be met before the takeover of any company employing employees can be carried out.

Indeed, the company's employees have to be informed before the transaction is carried out so that they are able to make an offer to the seller prior to the third party making an offer.

Similarly, the target's working council has to be consulted sufficiently in advance of the transaction.

In so far as this information and consultation must be carried out before the sale takes place, it is not strictly speaking a condition precedent. The most commonly used formula is the signing of a put option, allowing the seller to exercise the option once the information/consultation obligations have been fulfilled.

6.5 "Hell or High Water" Undertakings

This type of clause concerns, in principle, transactions of considerable size. The acceptance by the purchaser of such a clause clearly depends on the negotiating power of each party, but especially on the applicable regulatory provision concerned.

When the regulatory provision relates to competition law, and particularly to antitrust provisions, this clause is difficult to accept for the purchaser. Agreeing to it is dangerous as the remedies can be harsh and costly.

On the other hand, in the case of a provision pursuant to foreign investments in France, the negotiation of this type of clause seems to be easier. Indeed, prohibitions are very rare and remedies are easier to implement in this context. "Hell or high water" clauses are therefore less difficult to take on in this context.

In any case, this is a matter of bargaining power and the specific situation of the purchaser. If it is a private equity firm with no competing companies in the portfolio nor in the context of a build-up, a "hell or high water" clause is more likely to be accepted.

6.6 Break Fees

Although not specifically prohibited by French law, break fees in favour of the buyer or the seller are not commonly used in France.

If stipulated, break fees will become due if either party decides to terminate a pending deal for a reason not attributable to the other party.

That being said, it is important to bear in mind that there are no punitive or exemplary damages under French law. Therefore, if the amount of the break fees exceeds the value of the damage actually suffered by the claimant party, the amount of such termination fees can be reduced by a court decision.

6.7 Termination Rights in Acquisition Documentation

Acquisition agreements in France usually contain a right to terminate the transaction if the conditions precedent are not fulfilled or are waived before the contractually agreed long-stop date. Moreover, if a MAC clause is set forth in the acquisition agreement, the buyer is entitled to cancel the deal if the target's business and operations suffer a material adverse change during the interim period (ie, between signing and closing). The duration of the long-stop date depends on the nature and number of condition precedents involved but is usually between three and six months.

6.8 Allocation of Risk

The allocation of risk generally depends on the negotiation leverage of the parties involved in the transaction and therefore may vary from deal to deal.

From a legal standpoint, the risk related to the acquired target company is supported by the purchaser unless provided otherwise in the sale and purchase agreement.

Usually, the sale and purchase agreement provides a representations and warranties mechanism pursuant to which the seller can indemnify the purchaser if the target suffers a liability as a result of events prior to closing.

There is usually a limitation on the amount of the liability of the seller, such as:

- a cap (stated between 10% and 30% of the purchase price);
- a threshold or a franchise; and
- a de minimis.

In private equity deals, more risks are taken by the purchaser since the representations and warranties are usually more limited (and sometimes there are almost none, except for the fundamental ones, eg, capacity, titles to share, etc).

6.9 Warranty and Indemnity Protection

When selling off their stakes, private equity funds are generally reluctant to make representations and guarantees other than warranties of title and capacity.

In contrast, the representations and warranties given by the management team usually cover a broad range of topics. Such warranties may, for instance, include:

- warranties regarding the target's financial situation and financial statements;
- warranties regarding the conduct of business;
- operational warranties; and
- warranties regarding compliance with all the applicable laws and regulations.

As mentioned in **6.8 Allocation of Risk**, representations and warranties are usually limited by a cap, a franchise/threshold, and a de minimis.

The liability of the seller can also be limited by the duration of the warranties, which is usually from 12 to 36 months.

Finally, it is worth noting that full disclosure of the data room is typically allowed against the warranties in open bid.

6.10 Other Protections in Acquisition Documentation

The other protections included in acquisition documentation mainly consist of an escrow agreement set between 25% and 50% of the cap.

The purchaser also often asks the seller to find a guarantor who may have to commit personal funds.

Also, in the biggest deals, the stakeholders may contract representation and warranty insurance.

6.11 Commonly Litigated Provisions

In the French jurisdiction, the provisions that are most likely to lead to a dispute relating to private equity transactions are those that provide for completion accounts and earn-out mechanisms. They are a breeding ground for litigation, despite their good drafting. Nevertheless, and despite the adjustment discussed above, the private equity market remains a pro-seller mar-

ket and locked-box mechanisms are becoming more common.

Similarly, warranties indemnification may give rise to litigation when implemented.

7. Takeovers

7.1 Public-to-Private

Public-to-private deals are uncommon in France.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

In France, shareholders acting either alone or in concert with others are required to disclose their stakes in publicly traded companies when exceeding or falling below one of the following thresholds (whether in capital or voting rights): 5%, 10%, 15%, 20%, 25%, 30%; 33.33%, 50%, 75%, 90% and 95%.

The French Commercial Code also requires the shareholder, when crossing certain thresholds of shareholding (10%, 15%, 20% and 25% of the capital and voting rights) in a publicly listed company, to declare the objectives they plan to pursue during the next six months.

If one of the aforesaid thresholds has been reached, the relevant investor must file a report with the French Financial Markets Authority (*Autorité des Marchés Financiers* or AMF) – with a copy to the issuer – within four trading days.

Failure to comply with this disclosure requirement may lead to a suspension of the voting rights attached to the shares exceeding the threshold that should have been disclosed, for a period of up to two years.

7.3 Mandatory Offer Thresholds

Under French law, there are two situations in which the obligation to make a mandatory offer for 100% of the shares of a publicly listed company can arise:

- when a person or entity, acting alone or in concert with any other party, exceeds 30% of the voting rights or the share capital of the target company; or
- if a shareholder who already holds between 30% and 50% of the target's share capital or voting rights increases its stake by 1% or more within 12 consecutive months.

In either case, the mandatory offer price must be at least equal to the highest price paid by the bidder for securities of the target during the 12 months preceding the obligation to file such mandatory offer.

It should be noted that exemptions and dispensations from the obligation to file a mandatory offer may be granted by the AMF in certain limited circumstances, including the following:

- subscription to a capital increase of a company in financial difficulty, subject to the approval of the shareholders' general meeting;
- merger or asset contribution subject to the approval of the shareholders' general meeting; and
- the holding of the majority of the company's voting rights by the requesting party or by a third party, acting alone or in concert, etc.

If the required mandatory offer is not filed, voting rights exceeding the 30% threshold will be suspended.

7.4 Consideration

In France, cash (rather than stock) is by far the most common consideration for financing an M&A transaction. Indeed, offering cash instead of shares enables the buyer to avoid dilution of its own shareholders. Thus, controlling stakes at the level of the buying company remain unchanged.

7.5 Conditions in Takeovers

Takeover bids may be subject to certain conditions precedent. In general, the conditions precedent accepted by the AMF are the following:

- the obtainment of antitrust approvals;
- if the offer includes stock as consideration, authorisation of the issuance of new shares of the offeror by its shareholders' meeting;
- reaching a certain threshold of target shareholder participation (in capital ownership or voting rights); and
- the success of two tender offers conditional upon each other.

However, conditions precedent relating to the obtainment of financing by the bidder are not accepted.

7.6 Acquiring Less Than 100%

Squeeze-Out Mechanisms

A squeeze-out procedure can be launched every time a given shareholder, acting alone or in concert with others, reaches no less than 90% of the target's voting rights.

If the 90% threshold is reached following the closing of a tender offer, the squeeze-out procedure can be implemented immediately, provided that the offer prospectus expressly mentions the bidder's intention to proceed with a squeeze-out.

7.7 Irrevocable Commitments

Commitments to tender shares from actual shareholders depend on the way the takeover is structured. Takeovers involving the participation of the shareholders of the target (and especially friendly takeovers) are usually structured in two different ways:

- a block of shares sold by the shareholders of the target to the bidder with an immediate transfer of ownership and then the launch of a tender offer by the bidder; or
- a tender commitment – in this case, the bidder undertakes to launch a public offer for the target at a price agreed on with one or more shareholders, who will then tender their shares at such price.

The choice is important in the bidding process, and is made on a case-by-case basis.

In the case of a simple sale of a significant block, the risk of a competing bid by another candidate will be reduced or even eliminated if the bidder has acquired the majority of the capital.

On the other hand, the purchaser will have to obtain any necessary antitrust clearances prior to the acquisition of the block which may delay the public offer process.

Moreover, in the case of a minority block acquisition, the acquirer will run the risk of holding a non-controlling interest if few shares are tendered to the public offer. In the event of an acquisition giving the shareholder a stake of more than 30% of the capital or voting rights, the bidder will be in a mandatory public offer situation, with price control by the AMF.

In the case of a commitment to tender, the bidder only acquires ownership of the reference

shareholders' shares at the time of settlement of the takeover bid. Thus, the bidder acquires these shares at the same time as the shares tendered by the other shareholders. If the bidder does not reach the 50% condition threshold set by French law or the condition threshold freely set by the bidder, the bidder will not acquire any shares and will not find itself a minority shareholder of the target.

On the other hand, the AMF requires that the undertakings to tender be revocable in the event of a competing bid. Thus, the bidder must accept the risk that the shareholders who have given the commitment to tender may sell their shares to a competitor in the event of a better bid.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Private equity funds often give key managers the opportunity to take part in a transaction by investing alongside them in the target.

To this end, an SPV gathering all key managers ("ManCo") is often created. The stake of ManCo in the target company usually ranges from 5% to 15%, depending on the characteristics of the deal. In an MBO (management buyout) situation, the management obviously has the majority of the capital.

The indirect participation of managers in the target is generally preferred over direct participation, mainly because the former scheme is more practical in terms of corporate governance.

8.2 Management Participation

In general, management participation in private equity transactions is structured through a management package, which may take the form of ordinary shares, sweet equity and/or fixed-rate instruments.

The idea is to align the interests of the management with those of private equity investors. To this end, managing shareholders benefit from higher returns on their investment.

Tax Implications

In practice, incentive schemes may vary according to tax considerations. For instance, in order to avoid tax liability, managers should acquire their shares or equity-linked instruments (warrant, preferred shares, etc) at a purchase price equal to the shares' fair market value. Nevertheless, France's highest administrative court issued three decisions on 13 July 2021 (confirmed on 17 November 2021) that changed this approach since even if the shares or equity-linked instruments have been acquired at fair market value, the capital gain in relation to such shares/instruments can be qualified as salaries and wages if it can be proven that the benefit of those shares/instruments is essentially linked to the status of the employee or officer of the beneficiary.

Consequently, in the case of requalification from the tax administration, the capital gain realised on the sale of these shares/instruments would be taxed in the category of salaries and wages (progressive tax up to 45% instead of a flat tax of 30% on the capital gain).

These decisions have been and will be commented on, and the consequences of these decisions are still being analysed by tax specialists, but all the commentators agree that these decisions are creating legal and tax insecurity on incentive schemes.

8.3 Vesting/Leaver Provisions

In private equity transactions involving management participation, good and bad leaver provisions are usually set out in the shareholders' agreement.

In general, a manager is deemed to be a "good leaver" if they leave the company for one of the following reasons:

- death;
- physical or mental incapacity; or
- departure approved by the investors.

In this case their shares will be transferred back to the portfolio company or the private equity investors, as the case may be, at fair market value.

On the contrary, if the relevant manager is deemed a "bad leaver", their shares will be transferred at a price lower than the fair market value. In general, a manager is considered a "bad leaver" if they leave the company:

- for any reason other than death, physical or mental incapacity, or upon authorisation by private equity investors; or
- in the case of gross negligence, wilful misconduct, breach of the shareholders' agreement or, in certain cases, under-performance.

In both cases, managers are required to sell their shares back to the company or the private equity investors. To this end, each manager must grant a call option to the private equity fund.

Following the case law of 13 July 2021 (see **8.2 Management Participation**), market practice tends to abandon the distinction between good and bad leavers and the correlative discount in order to minimise the link between the employment agreement and the investment (and minimise the risk of reclassification of the capital gain as salaries and wages).

8.4 Restrictions on Manager Shareholders

Manager shareholders often play a dual role, as they are both shareholders and employees or service providers of the portfolio company. Given this situation, manager shareholders are subject to certain obligations deriving directly from their status. Such obligations usually include non-solicitation, non-competition and confidentiality obligations, which are set out in both the shareholders' agreement and the employment contract (or service agreement) signed by the relevant manager.

Under French law, the non-competition undertaking must be proportionate to the legitimate interests involved. To this end, these commitments are limited in time and space and to strictly defined activities. Moreover, if the manager who undertakes such a commitment is an employee, the non-competition undertaking must be stipulated in the employment contract and must be remunerated.

8.5 Minority Protection for Manager Shareholders

In the case of a majority LBO, the manager shareholders of a company do not have specific rights that would allow them to influence certain decisions that would commit the company or the structure of the company itself. Nor, for the majority of deals, do they have specific rights to influence the capital ownership or the exit of the investor. Indeed, the main purpose of managers taking a stake in a company is to give employees an interest in the company's results.

Moreover, certain important decisions need to be approved by the investors.

As an exception to the above, however, some managers may be offered certain rights as a party to an investment agreement. The content of these rights depends mainly on the negotiating capacity and the final weight that the management team is expected to carry in the company following the investment. This can go as far as veto rights on certain issues involving the company, anti-dilution protection or influence on the exit of the private equity fund.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

Corporate Governance

In order to monitor the performance of a portfolio company, private equity investors usually negotiate the following corporate governance arrangements, which are generally set out in the shareholders' agreement:

- appointment of representatives in the supervisory committee;
- veto rights on strategic decisions; and
- information and audit rights.

Nomination of supervisory committee members

Most private equity investors are granted the right to appoint a certain number of members of the supervisory committee. Such members represent the interests of the private equity fund at the level of the committee, the main role of which is to monitor business performance and vote in strategic decisions.

Veto rights on strategic decisions

Besides the right to appoint members of the supervisory committee, private equity investors are usually granted veto rights over extraordinary management decisions affecting the organisation, structure or performance of the portfolio company, which may include:

- amending the company's by-laws;
- issuing additional shares or transferring shares;
- adopting financial budgets;
- incurring new debt above a certain threshold;
- hiring or dismissing directors and key employees;
- investing above a certain amount;
- setting up new subsidiaries or entering into a new line of business; and
- pursuing a merger, an acquisition or a carve-out; etc.

The list of strategic decisions is usually set out in the shareholders' agreement and is sometimes reiterated in the company's by-laws.

Information and audit rights

Information and audit rights are also commonly requested by private equity investors. Consequently, the management of the portfolio company has a reporting obligation towards investors and must provide financial reports to the private equity fund every month or at the end of every quarter.

Furthermore, as part of their audit rights, private equity investors are entitled to conduct on-site investigations and can therefore audit the company's books and records, either alone or assisted by legal advisers.

9.2 Shareholder Liability

In general, private equity investors do not wish to interfere with the daily management of the portfolio company, in order to limit their liability in this regard. Hence, private equity investors prefer to perform a supervisory role.

However, under certain conditions, private equity funds, in their capacity as shareholders, may be held liable in the context of their activity, and the principle of limited liability may be put aside.

Thus, when shareholders are found to have committed a personal error that cannot be linked to the management of the company and which has caused damage to others, it is established case law that the personal liability of the shareholder will be engaged.

Above all, shareholders will be personally liable if they are qualified as de facto managers. Thus, when a shareholder interferes in the management of the partnership in a manner that leads to a loss for the company, this interference will engage the personal liability of the shareholder.

This is why counsels of private equity funds have to draft the shareholders' agreement so carefully. Indeed, the rights that are granted to the fund have to remain information, reporting or veto rights on strategic issues. If the rights granted to the fund go further and grant it decision-making power, the fund may be held liable as a de facto manager.

10. Exits

10.1 Types of Exit

Most private equity funds expect to sell their investment and therefore exit the target company four to seven years after the deal's completion date, since the senior debt is granted for such a duration.

In the French jurisdiction, the most common forms of private equity exit include secondary buyouts, IPOs and trade sales. In numerous cases, the exit of the LBO can intervene by merging the holding company and the operating company before the launch of the IPO.

10.2 Drag and Tag Rights

The so-called drag-along clause is often used in private equity transactions. It is possibly even one of the most fundamental clauses.

Sometimes, the drag right is in the hands of the sole majority shareholder. Sometimes the threshold varies if there are several majority shareholders. It mainly depends on the negotiating power of each majority shareholder.

The so-called tag-along clause is also frequently included in private equity transactions. It can be drafted in two different ways:

- first, it can be a full tag-along right, allowing shareholders to transfer all of their shares to the purchaser for control of the company; or
- second, it may be a proportional tag-along right, the purpose of which is to allow the beneficiaries to transfer, together with a transferring shareholder, a proportional share of their holding.

This clause can typically be applied to institutional investors or to managers.

10.3 IPO

The lock-up agreement is a period during which the shareholders of a company undertake to hold the company's shares for a given period following an IPO. This period is usually quite short

and rarely exceeds nine months, although some clauses make the lock-up last for a year.

IPOs are typically subject to a lock-up arrangement of 180 calendar days.

This commitment is often made to reassure investors.

Shareholders' agreements can also be concluded after the IPO, in particular, for the management or to give a priority right in the event of a share transfer.

Trends and Developments

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General Overview

France, historically the second largest private equity (PE) market in Europe after the UK, has not been spared from the challenges faced by the global and European PE markets over the recent past period. French PE transactions' aggregated value fell by almost 15% in 2023 compared to 2022, due in particular to increased interest rates and a widening gap between sellers' and purchasers' expectations in terms of targets' valuation. In H1 2024, the French PE activity continued to shrink, with a circa 24% drop in aggregated value compared to H1 2023.

That being said, Q2 2024 was the second strongest quarter since Q4 2022 in terms of PE transactions' value in France, allowing room to be cautiously optimistic for the rest of the year. In particular, even if France's PE actors currently face additional specific challenges resulting from the country's recent political upheaval and limited economic growth, the ECB interest rate easement (after five years of consistent increase) should support the private equity activity in the coming months.

It is also to be noted that the PE sector in France remains particularly robust: France boasts a large number of leading international and domestic private equity firms, a balanced fundraising environment and French private equity investments have annually outperformed all other main investment classes (CAC40, real estate, hedge funds) over a ten-year spread.

Macroeconomic and Political Uncertainty Affecting the PE Market

In H1 2024, total deal value dipped to EUR27.6 billion, compared to EUR36.3 billion in H1 2023. In addition to lingering misalignment between buyers and sellers regarding asset valuations, interest rates remain high compared to previous years and political uncertainty, slowing growth and high public deficit are contributing to lower deal activity.

Political upheaval

There were immediate ramifications following the European Parliament elections and the snap election called by French President Emanuel Macron in June 2024. Business leaders and investors expressed unease about inexperienced policymakers and the potential rollback of pro-business/pro-investment reforms. These concerns triggered some instability in the European stock markets and the postponement or cancellation of transactions across Europe. For example, the Italian luxury sportswear brand Golden Goose (backed by Permira) postponed its Milan IPO exit due to market deterioration arising from political uncertainty in Europe and, specifically, France.

The political uncertainty and deadlock resulting from the current absence of a new government following the parliament dissolution coupled with the unprecedented composition – and lack of clear majority – of the newly elected French parliament may continue to create headwinds for the French PE market.

The upcoming US elections, along with the continuing international instability, may also affect the PE activity from a global standpoint in the coming months.

Slowing economic growth and rising public deficit

France has so far avoided a recession (unlike some of its neighbours) and posted a modest 1.1% growth in GDP for 2023 (compared to 2.5% in 2022). In July 2024, the International Monetary Fund predicted that the French GDP would only grow by 0.9% for 2024.

The country's significant public debt and the deteriorating budgetary situation are also causing concern. The country's debt ratio, the third highest in Europe, caused France's rating downgrade in 2023 by Fitch, followed by a 2024 downgrade by Standard & Poor's. The resulting higher borrowing costs will likely impede the government's efforts to lower the deficit and reach its target of 3.0%, which could potentially renew fears of tax increases and negatively impact deal activity.

Record High Dry Powder Levels and Signs of Relative PE Fundraising Slowdown

H1 2024 saw limited fundraising activity with only EUR4.8 billion raised, compared with 2023, a very active year on the fundraising front with EUR21.3 billion capital raised in aggregate. The slowdown in H1 2024 is not necessarily the reflection of gloomy perspectives on the PE market; following a particularly active fundraising environment over the past few years in France, there is a very significant level of dry powder available. As of 31 December 2023, the level of dry powder amounted to almost EUR50 billion, representing a circa 243% increase over a 10-year period and a circa 35% increase since 2020. Given the requirement for sponsors to deploy the funds committed by limited partners within a limited period of time, this dry powder level should support an upcoming uptick in PE deal activity.

On another note, a new sort of momentum in the fundraising landscape may result from the introduction in early 2024 of the European Long-Term Investment Funds 2 Regulation (ELTIF 2) which should favour the democratisation of the PE world for retail investors by addressing many of the constraints previously imposed (such as minimum investment requirement, required amounts for certain eligible assets, etc). It is way too early to predict if these new funds will be successful, but it is a promising development for the European and French PE market.

In terms of the number of funds raised, a clear slowdown can be noted since 2021, with a drop by circa 57% between 2021 and 2023, which should also be understood in light of the increase in the size of the funds raised in France.

As for funds' profiles, France benefits from a more diverse fundraising environment than other European countries, resulting in a well-balanced representation of the various categories of funds.

Subdued PE Deal and Exit Activity

Robust PE deal activity in spite of a relative slowdown

As mentioned in the general overview above, the level of PE activity has undergone a downturn since 2021, with a decrease in value by circa 5% between 2021 and 2022, by circa 14% between 2022 and 2023 and by circa 24% between H1 2023 and H1 2024. This slowdown has been driven by several factors in addition to the macroeconomic and political uncertainties described in sections above. On the one hand, reasonably priced private targets have remained scarce, with sellers' valuation expectations remaining pretty high over the past period; on the other hand, significant financing costs have limited the valuation multiple sponsors can afford. The valuation gap has resulted in longer and more complex negotiations as part of the transactions; in particular, legal mechanisms permitting to reconcile sellers' and purchasers' views (earn-out provisions, price adjustments, vendor loans, etc) are seen, more than ever, as central aspects of the deal parameters and have given rise to lengthy discussions as part of the deals process.

That being said, the number of transactions has remained quite stable over the same period, evidencing that the market remains dynamic and that actors have managed to carry out transactions and secure the required acquisition financings; in this respect, it is to be noted that the financing landscape saw a diversification of funding sources over the past few years, including through larger recourses to private debt.

In terms of sectors, the renewable energy field has proven to be attractive for PE transactions, which should continue to be the case in the future. From a general standpoint, and in light of the entry into force of the Corporate Sustainability Reporting Directive (CSRD), ESG tends to become a more central aspect of investment policies, granting a competitive advantage to targets that adopt a clear and transparent ESG approach or operate in businesses aligned with ESG constraints. As a side note, it is expected that compliance with the requirements derived from CSRD will constitute a great challenge for PE sponsors and portfolio companies in the coming months and will be a key area of focus.

Echoing trends seen across Europe, jumbo deal (EUR1 billion or more) activity has declined in France's PE market, with a circa 53% drop in jumbo deals' value between 2020 and 2023. So far in 2024, only two megadeals were concluded in France (the EUR1.6 billion take-private of Believe by a consortium including EQT and TCV and the EUR3.5 billion acquisition of Neoen by Temasek and Brookfield). In comparison, at least five jumbo deals were announced in H1 2023, including Brookfield's circa EUR3.5 billion acquisition of Data4, one of the largest deals, globally, of the year.

The average PE deal value in France has been relatively stable over recent years (circa EUR62 million for H1 2024 compared to circa EUR60 million for 2023 and circa EUR59.9 million for 2022), although a decrease can be noted in the long run, with an average deal value of circa EUR74.9 million in 2019 or circa EUR77.6 million in 2020.

Consolidation in the PE industry is also a notable trend in France (eg, potential acquisition of AXA Investment Managers (AXA IM) by BNP Paribas, acquisition of Capza by AXA IM), resulting in a rise of "GP stake" transactions. Certain players, such as Armen, are even dedicated specifically to this type of transaction.

Robust cross-border PE activity

International PE firms are particularly active in the French market and cross-border PE transactions represented almost half of the PE deal value in H1 2024 in France (but only circa 33% of the deal count), quite in line with the proportion observed for full year 2023. Even if certain analysts consider that the French market is affected by heavier regulations and higher tax than in other European jurisdictions, non-European sponsors continue to see the French market as a strong PE hub in Europe, consistently second after the UK in terms of market size.

In terms of the number of deals, French PE actors remain in a leading position in the French market, with Bpifrance, BNP Paribas Développement and Siparex Group being referenced as the top three PE investors over the period from 2020 to Q2 2024.

A declining exit activity over the past periods and signs of rebound

Since 2021, France's PE exit activity has fallen sharply in value from EUR58.5 billion in 2021 to EUR45.3 billion in 2022 and EUR41.7 billion in 2023. In H1 2024, the value of exit transac-

tions amounted to EUR15.8 billion, compared to EUR28.5 billion in H1 2023.

The lack of public listing plays a role in the lack of exits in France; in fact, there was not a single public listing from a PE-backed company in 2023 and only one so far in 2024 (Exosens, for circa EUR1 billion). However, it should be noted that the depressed IPO environment may, on certain occasions, favour PE transactions: the French pharmaceutical giant Sanofi, for instance, was hoping to spin out its consumer healthcare business via an IPO, but now seems to be leaning towards a PE bid.

There are, however, signs of a rebound on the exit front: Q2 2024 was, for instance, the third highest quarter in terms of PE exit value since Q2 2022. Also, certain evolutions in French laws and regulations should support a new momentum on the IPO market:

- A new legal framework was recently adopted, designed to make the Paris financial markets more attractive, in particular through the introduction of multiple voting rights and the simplification of share capital increases without preferential subscription rights.
- The board of the French market authority (*Autorité des marchés financiers*) amended its general regulation in March 2024 to cancel the requirement for a retail tranche offering as part of IPO processes; this more favourable and attractive IPO regulation may support a new momentum of PE exits through public markets.

GERMANY

Law and Practice

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Willkie Farr & Gallagher LLP is one of the few major law firms with extensive domestic and international experience in virtually every type of private equity transaction, ranging from cross-border multibillion-dollar leveraged buyouts to early-stage venture capital financings. As a recognised leader in private equity transactions, fund formation and regulatory compliance, Willkie regularly represents private equity investors, issuers and financial advisers in all aspects of domestic and international private equity transactions. Due to Willkie's longstanding representation of many international private equity and venture capital institutions, its attorneys routinely work on sophisticated private equity transactions such as leveraged buyouts, management buyouts, spin-offs, growth equity investments, venture capital financings, take-private transactions, recapitalisations and dispositions. Willkie also represents a number of institutionally backed private enterprises (including portfolio companies of the firm's private equity and venture capital fund clients) in connection with their financing, M&A and general corporate needs. Willkie's experience covers a broad cross-section of industry sectors, including manufacturing, services, finance, insurance, technology, software, retail, real estate, gaming, biotechnology, medical devices, communications and media.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

The private equity market in Germany is experiencing a notable recovery in 2024 following the challenges faced in 2023. Although high interest rates, energy prices, and inflation continue to present obstacles to market growth, the situation has stabilised. The robust recovery of the private equity market in the United States and across Europe is positively influencing the investment climate in Germany.

In light of the persistent but stabilised high costs and the reduced availability of debt funding, the focus has shifted towards smaller to mid-sized transactions with lower funding requirements recently, but we are starting to see a comeback of large cap transactions. Investors are increasingly engaging more strategically with potential assets, often participating in early auction screenings or seeking exclusive negotiation agreements. In the case of high-profile targets, investors remain cautious but are occasionally prepared to accept minority shareholdings. This approach is largely driven by the significant levels of "dry powder" held by private equity funds, which creates pressure to deploy capital effectively.

The trend of fund-to-fund deals, where ownership of a company remains within the same private equity house, continues to be strong.

1.2 Market Activity and Impact of Macro-Economic Factors

In 2024, the technology, healthcare, and industrial goods sectors have emerged as key areas of focus for M&A activity in Germany. The technology sector, particularly companies involved in information technology, has seen significant interest, due, inter alia, to the rapid advancements in artificial intelligence. Further, carve-out activity is increasing to create standalone entities with specialised management teams and refined business strategies, aimed at unlocking hidden growth potential.

Higher interest rates and other macro-economic factors have significantly impacted deal-making in Germany over the past twelve months. The rise in interest rates has widened the valuation gap between sellers' expectations and what buyers are willing to pay, complicating transactions in the current financing environment. As a result, refinancing has become an increasingly attractive option to manage the ongoing high-interest environment. However, the stabilisation of interest rates has expanded the range of available financing options compared to 2023, allowing for more flexible deal structures.

The ongoing conflict in Ukraine continues to act as a significant impediment to any M&A activity involving Russia. It is now common practice for any Russian subsidiaries to be divested before closing, making it an often-seen condition precedent in the sale and purchase agreements (SPAs) for deals involving German companies with Russian assets.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Foreign Direct Investment Reform

Germany's Foreign Direct Investment (FDI) reforms in 2020 and 2021 have significantly impacted private equity transactions, particularly in sectors critical to national security, such as ICT, healthcare, biotech, energy, and hi-tech industries like aerospace and semiconductors.

The amendments to the German FDI regime expanded the scope of sectors under FDI review, increasing scrutiny on foreign-backed investments and adding complexity to due diligence and transaction planning. The FDI process now requires thorough preparation to navigate these challenges. As of late 2023, the FDI screening process transitioned to a fully digital procedure.

German Competition Act Reform

The latest reform to the German Competition Act (*Gesetz gegen Wettbewerbsbeschränkungen* GWB) tightened competition law by introducing a new tool for the Federal Cartel Office to address market disruptions, even without evidence of unlawful behaviour. This is particularly relevant for private equity firms with portfolio companies in concentrated markets, as it increases regulatory oversight and potential intervention. The reform also enhances the authority's ability to absorb anti-competitive practices, adding complexity to transaction planning and execution. A new reform is in progress to further modernise competition law.

EU Foreign Subsidies Regulation

The EU Foreign Subsidies Regulation (FSR) adds scrutiny to private equity transactions involving foreign subsidies. The FSR requires substantive approval for concentrations if the target or parties involved meet certain turnover and subsidy thresholds. This regulation has become a crucial consideration in the transaction process. Early cases indicate the FSR's growing influence, particularly in cross-border deals. In June 2024, the European Commission initiated its first in-depth investigation under the FSR, scrutinising Emirates Telecommunications Group's acquisition of PPF Telecom Group over concerns about foreign subsidies.

ESG and Supply Chain Compliance

The German Act on Corporate Due Diligence Obligations in Supply Chains (LkSG), the EU Corporate Sustainability Reporting Directive (CSRD) and the EU Corporate Sustainability Due Diligence Directive (CSDDD) have significantly increased compliance obligations for private equity portfolio companies as well as for private equity companies themselves. Since January 2024, the LkSG applies to companies with more than 1,000 employees, requiring the implementation of comprehensive due diligence processes to ensure respect for human rights and environmental standards across (direct and indirect) supply chains. These developments are driving private equity firms to integrate environmental, social, and governance (ESG) factors more deeply into their investment strategies, reflecting the growing importance of environmental, governance and social factors such as sustainability and human rights in the regulatory landscape.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Private equity transactions in Germany may be subject to both merger control by the Federal Cartel Office and FDI screening by the Federal Ministry for Economic Affairs and Climate Action (*Bundesministerium für Wirtschaft und Klimaschutz* – BMWK). These authorities enforce German and EU competition laws while assessing national security risks. The Federal Cartel Office operates independently and is not subject to political directives, despite being assigned to the BMWK.

Merger Control

Merger control is mandatory for transactions that meet specific thresholds, requiring private equity-backed buyers to account for these regulations during transaction planning. This is especially important in concentrated sectors, where potential merger control risks could impact future exits. The majority of notifiable private equity transactions are cleared in Phase 1, although exceptions occur, confirming the general rule.

FDI Screening

Recent legislative changes in Germany (see above) have tightened FDI screening, expanding the number of sectors covered and lowering filing thresholds. The screening process differentiates between sector-specific reviews for sensitive areas like military, defence, and IT security, and cross-sectoral reviews for critical infrastructure, biotech, and AI. The FDI rules apply more rigorously to non-EU/EFTA investors and are particularly stringent for investors from countries such as China. The BMWK tends to scrutinise investments from these regions more critically. Although the total number of cases reviewed by the BMWK has decreased since 2023, the overall level of scrutiny remains high. Fewer cases have required in-depth reviews, and the percentage of cases facing restrictive measures has remained stable.

EU Foreign Subsidies Regulation (FSR)

The new EU FSR applies to any company operating within the EU, including those involved in private equity transactions in Germany. It adds a layer of scrutiny to deals involving foreign subsidies, making it a more and more common closing condition alongside antitrust and FDI clearances. Early cases under the FSR emphasise its growing significance, particularly in cross-border private equity transactions. The recently initiated first in-depth investigation under the FSR, involving a UAE state-owned telecom provider, highlights the extensive time frames and importance of such investigations for private equity deals. It remains to be seen to what extent private equity funds will be affected specifically by these new rules – in particular, there appears to be no clear guidance by regulators so far concerning, for example, the question of whether investments into funds' limited partners by investment entities of foreign governments may qualify as subsidies under the FSR.

Sanctions and Export Controls

On sanctions and export controls, the EU recently gave final approval to the introduction of a law covering EU-wide minimum rules for the prosecution of violation or circumvention of EU sanctions in member states, requiring private equity investors to scrutinise even more both investment decisions as well as management of portfolio companies. On ESG, in addition to the broader supply chain due diligence-related laws mentioned above, compliance with industry-specific regulations such as the EU Deforestation Regulation (EUDR) is becoming more and more crucial for investment decisions.

4. Due Diligence

4.1 General Information

Typically, a high level of legal due diligence is conducted to identify potential major risks and issues associated with the target and its business. This comprises the review of documents provided by the seller in the (predominantly virtual) data room (VDR) and information obtained from public sources, in particular the commercial register, the land registers and from public authorities. Identified key findings are typically described in a legal (red flag) due diligence report. This report also provides the client with

recommendations on how to mitigate the risks arising from the transaction and comments on the commercial implications of these risks.

Usually, the legal due diligence compromises corporate law, commercial contracts, finance, employment, intellectual property, IT and data protection, real estate, compliance, insurance and litigation. However, the scope needs to be tailored to the specific target and needs of the investor and the key areas of focus depend on various factors, in particular the industry in which the target operates. Furthermore, the scope is dependent on external influences such as global crises (eg, the COVID-19 pandemic, wars) which affect supply chains, price adjustments, sanctions and the overall legal framework.

Due to the development in the private equity market described above, there is an increasing focus on IP, IT (including cybersecurity) and data protection matters as well as on new regulations such as ESG compliance.

4.2 Vendor Due Diligence

For private equity sellers, conducting vendor due diligence is nowadays more or less the standard, in particular for larger auction sales. In most cases, the sell side provides a legal fact book rather than a due diligence report in a formal sense – ie, a document which describes the facts in respect of the legal affairs of the target, but does not include a comprehensive assessment of potential risks and issues or recommendations.

Both forms (legal fact book as well as vendor due diligence report) facilitate a more streamlined transaction process and enable potential buyers to assess the target more efficiently. Furthermore, a vendor due diligence or a legal fact book gives the seller the advantage of identifying potential deal-critical issues in advance and allows it to properly address those issues before or during the transaction process.

Vendor due diligence reports as well as legal fact books are typically provided without reliance and potential buyers must sign a release letter in advance before access is granted. After obtaining these reports, buyers will typically conduct additional buy-side (top-up) legal due diligence in order to ensure the accuracy of the vendor due diligence report or legal fact book provided by the sell side.

5. Structure of Transactions

5.1 Structure of the Acquisition

In Germany, the acquisitions by private equity funds are mostly carried out by way of a (private) share purchase and transfer agreement with the goal to buy (and acquire) a minority, majority or sole shareholding in the target from the seller (share deal). Tender offers for publicly listed companies occur from time to time, but are the clear exception in the private equity sphere. Privately negotiated SPAs offer flexibility and the ability to negotiate tailored terms directly between the buyer and seller. More rarely, private equity funds buy selected assets, liabilities and obligations from the company (asset deal). Since asset deals tend to be more burdensome for all involved parties, they are usually utilised only in cases where a specific reason exists to do so – eg, in certain carve-out scenarios or in distressed deal situations.

Both one-on-one and auction processes are common in private equity transactions. As a tendency, the larger the target is, the more likely it is that a sale will be structured by way of an auction rather than a one-on-one process. In one-on-one processes, the private equity buyer often

has more influence over the deal terms, including representations and warranties, indemnities, and price adjustments. This allows for a more customised approach to risk allocation and deal structure.

In contrast, an auction sale typically involves multiple bidders, leading to a more competitive environment. The seller often dictates (certain) key terms of the sale, which are set forth in a standardised sell-side SPA with limited room for negotiation. Auction processes tend to result in higher purchase prices for sellers and often come with tighter timelines and less flexibility for private equity buyers to conduct extensive due diligence or negotiate individual terms.

5.2 Structure of the Buyer

Private equity-backed buyers are typically structured through a series of special purpose vehicles (SPVs), with the most common structure involving a bidding company (BidCo) that directly acquires the target company or group. These SPVs are typically incorporated in Germany, mostly as German limited liability company (*Gesellschaft mit beschränkter Haftung* – GmbH), and/or in countries with a favourable tax environment for private equity investments (typically Luxembourg, the Netherlands or the Channel Islands). The private equity fund itself generally remains at a higher level in the ownership chain and does not directly involve itself in the acquisition or sale documentation, except for providing commitments under equity commitment letters. Instead, the BidCo or other SPVs are the entities that enter into the transaction agreements and hold the investment. Under German law, the execution of the SPA and the transfer of the shares typically require the involvement of a notary – notarisation is mandatory for the acquisition of shares in limited liability companies, being by far the most common legal form in the German market for private equity investments.

5.3 Funding Structure of Private Equity Transactions

Deals are typically financed through a combination of equity from the private equity fund and external debt. The equity portion is often secured through an equity commitment letter, which provides contractual certainty that the private equity fund will supply the necessary equity to consummate the transaction at closing. This commitment is especially critical in competitive transactions, where sellers require strong assurances of the buyer's financial capability to complete the deal without delays or financing failures. Due to German notarisation requirements, where a limited liability company is the target, equity commitment letters are typically notarised together with the main transaction documentation.

For the debt portion, it is common to evidence committed debt financing in place at the time of signing the purchase agreement – debt commitment letters are typically attached to SPAs in such situations.

In addition, it is standard in German SPAs to include representations and warranties of the purchaser in the SPA, guaranteeing that the purchaser has/will have the required financing sources required to consummate the transaction available at closing.

Over the past year, with financing conditions becoming more challenging due to economic uncertainties and rising interest rates, there has been a noticeable shift toward securing more robust financing commitments early in the deal process. Additionally, there has been a growing trend toward using alternative financing sources,

such as private credit funds or vendor loans, to overcome impediments in a tighter credit environment.

5.4 Multiple Investors

Deals involving a consortium of private equity sponsors are not particularly common but do occur in specific circumstances, especially in large to very large transactions where pooling resources and expertise is necessary. Co-investment by other investors alongside the lead private equity fund is more common. These co-investments typically involve passive stakes by limited partners (LPs) already invested in the fund, though participation of external co-investors, such as family offices or institutional investors, occurs from time to time as well. Consortia that include both private equity funds and corporate investors are relatively rare but can be strategically valuable when the corporate investor offers industry-specific expertise or synergies.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

In German private equity transactions, the predominant consideration structures are fixed-price mechanisms with a locked box and completion accounts. The locked-box approach was more common in recent years and is particularly favoured by sellers for its price certainty, fixing the value at a specific date pre-closing, thereby minimising post-closing adjustments and potential for disputes. With the end of the seller bull market and a tendency to see more corporate carve-out transactions, the more buyer-friendly and, in respect of carve-outs, more flexible closing accounts mechanism has recently gained popularity when compared to recent years. Earn-outs and deferred considerations are also common, especially to bridge valuation gaps or align incentives, although earn-outs can be contentious due to performance disputes.

Private equity involvement typically influences the choice of consideration mechanism. Private equity sellers often prefer locked-box structures to ensure a clean exit with minimal post-closing exposure, while buyers might favour completion accounts or earn-outs to tie the price to the actual performance of the target.

6.2 Locked-Box Consideration Structures

Fixed price locked-box consideration structures are commonly used. It is typical for “interest” to be charged on the equity price during the locked-box period to compensate the seller for the time value of money, usually calculated from the locked-box date to the closing date. This locked-box “interest” is often structured as a pre-defined daily cash amount rather than an interest rate, such amount being based on calculated cash flows of the target rather than interest rates on the debt markets.

It is not particularly common to include provisions for charging reverse interest on any leakage that occurs during the locked-box period. In cases where such concept is used, the reverse interest is typically designed to penalise the seller for such leakage and protect the buyer’s interests.

6.3 Dispute Resolution for Consideration Structures

It is common to have a dedicated expert or other dispute resolution mechanism in place to address issues related to consideration structures. This is obviously mainly relevant for transactions without a fixed purchase price as of the signing date – ie, deals using completion accounts or earn-

outs, where the final purchase price depends on specific metrics or post-closing financial performance. In these cases, disputes may arise over the interpretation of accounting standards or the calculation of financial results, making a neutral expert crucial for resolving disagreements efficiently.

For locked-box structures, the need for a dispute resolution mechanism is less pronounced, given the fixed nature of the price. Depending on other features of the individual SPA (eg, earn-outs) it may, however, still make sense to include provisions for an expert determination in the event of disputes.

6.4 Conditionality in Acquisition Documentation

Transactions in the German market generally exhibit a relatively low level of conditionality beyond mandatory and suspensory regulatory conditions. It is uncommon to include conditions related to financing, as the financing risk is traditionally seen as a pure purchaser risk that should not affect the transaction. Third-party consents as closing conditions, such as consents from key contractual counterparties (ie, usually crucial customers or suppliers), are more common, but are generally limited to critical contracts without which the conduct of the target business would be impossible or at least significantly less attractive. Conditionality in respect of shareholder approvals (ie, actions which are solely in the hands of one involved party) is almost unheard of in the German market; instead, the representations and warranties to be granted by both parties usually include explicit guarantees that all such required approvals have been obtained.

Material adverse change (MAC) or material adverse effect (MAE) provisions are much less prevalent in German private equity transactions compared to other jurisdictions, but they are used in certain cases, particularly where the target business is subject to significant external risks. When included, MAC/MAE clauses are often heavily negotiated, with a narrow scope in order to avoid deal uncertainty. Further, such clauses will usually not be structured as (negative) closing conditions, but rather as rescission rights.

6.5 “Hell or High Water” Undertakings

It is uncommon for private equity buyers to accept hard “hell or high water” undertakings for regulatory conditions due to the high risks involved. Private equity firms typically prefer “reasonable best efforts” commitments and would usually exclude divestment obligations in respect of other portfolio companies. As an exception, “hell or high water” clauses may be accepted in cases where the regulatory assessment comes to the conclusion that the risk is rather remote and where transaction dynamics require a more flexible approach. Even in such cases, however, most private equity investors will not accept break fees triggered by any failed regulatory condition.

There is a distinction between merger control, where buyers might be more flexible depending on the individual antitrust assessment, and foreign investment conditions, where caution prevails since results tend to be more political and, thus, less predictable.

6.6 Break Fees

Break fees (or termination fees) are sometimes requested by sellers if a deal fails to close by the longstop date, usually due to a lack of merger (or other regulatory) clearance. As a general rule, most private equity buyers will not accept break fees in the German market.

"Reverse break fees", where the buyer would be compensated if the deal fails due to seller actions, are far less common in German private equity deals. While they gained some attention during periods of heightened market volatility, their usage has remained limited.

6.7 Termination Rights in Acquisition Documentation

In German private equity transactions, the parties usually exclude statutory termination rights in the SPA to the extent legally permissible, as the statutory law is considered too broad and not adapted to the needs of the parties. Instead, the parties establish limited contractual termination rights specific to the transaction which typically remain in effect only until closing.

Generally, the SPA includes a termination right in favour of both parties arising from the failure to fulfil the closing conditions by a designated longstop date, which usually falls between three and twelve months after signing the SPA. The exact period until the longstop date varies depending on the expected timeline for fulfilling the closing conditions (in particular regulatory clearances) and should leave additional room, in particular when the involvement of foreign authorities is needed. In debt-financed deals, it should also be noted that the longstop date must align with the financing agreement in order to avoid conflicts between the transaction and financing timelines.

Further, most SPAs contain mutual termination rights in the event that closing is not consummated due to a party's failure to perform closing actions within its responsibility, most notably the payment of the purchase price. Usually, grace periods apply in such cases.

6.8 Allocation of Risk

Private equity sellers, driven by the need to maximise returns for their limited partners, typically aim to minimise liability in transaction documentation. Unlike corporate sellers, they often push for low liability caps and shorter limitation periods to protect the proceeds from being diminished by potential liabilities under the share purchase agreement. In sell-side transactions, it is absolutely typical for private equity sellers to insist on a W&I-insured deal. Further, the appetite of private equity sellers to accept liability risks also strongly depends on the remaining life cycle of the invested fund – the shorter its remaining life cycle is, the more focused are private equity sellers to achieve a clean cut with only very limited residual liability risks.

In secondary transactions, where one financial sponsor buys from another, private equity buyers generally accept fewer and less extensive warranties than they would in deals with strategic sellers.

6.9 Warranty and Indemnity Protection

Private equity sellers typically offer limited warranties and indemnities on exit, focusing on title to shares, authority, and basic operational aspects. Liability, other than for title, leakage and certain other fundamental matters, is often capped at 10-30% of the purchase price, with claims limited to 12-24 months.

Tax indemnities, where granted, usually offer higher liability caps up to 100% of the purchase price and claim periods extending up to seven years; however, we have seen a strong tendency in particular among private equity sellers in the recent past not to grant tax indemnities in the SPA at all, and refer the buyer to a purely synthetical tax indemnity negotiated with the W&I insurance instead.

Management teams only very rarely provide additional warranties in German M&A deals. If they do, as an exception, this usually relates to operational matters, but their liability is usually capped at their equity stake, with similar or shorter claim periods than those of the selling private equity investor.

When both buyer and seller are private equity-backed, warranties are further limited, with a strong reliance on due diligence and W&I insurance solutions. Data room disclosure is typically allowed against warranties, significantly limiting the seller's liability.

6.10 Other Protections in Acquisition Documentation

Additional protections commonly included in acquisition documentation involve materiality thresholds and knowledge qualifiers in representations and warranties. "Sandbagging" clauses, where buyers are barred from claiming against known issues discovered during due diligence, are also frequently negotiated to limit post-closing liabilities.

Warranty and indemnity (W&I) insurance is nowadays very common in German M&A deals and prevailing in sell-side private equity deals. It is typically used to cover both fundamental and business warranties, offering protection to buyers without requiring substantial liability from the seller. W&I insurance can also – and often does – extend to tax matters (including tax indemnities), particularly in transactions where the parties seek to avoid time-consuming negotiations. Enhancements for the benefit of the purchaser are more or less standard in modern W&I-insured transactions. Also, purely synthetical tax indemnities have been increasingly used in the recent past. It is known in the market that also purely synthetical catalogues of reps and warranties may be offered by W&I insurers under certain preconditions – this concept, however, appears to have been very rarely tested in the market so far.

Escrow accounts or retention mechanisms have been rather uncommon in German private equity deals and in the overall German M&A market in recent years, as a result of the overall seller market. However, when they are used, they are typically applied to cover warranties or specific indemnities, providing an additional layer of security for the buyer. In such cases, the escrow amount is usually a small percentage of the purchase price and is held in escrow for a limited period of time, often aligned with the warranty periods.

6.11 Commonly Litigated Provisions

German private equity transactions very rarely lead to post transaction litigation or arbitration. Furthermore, private equity buyers often avoid legal disputes with sellers to prevent reputational risks that could deter future transactions. However, there has been a slight increase in such disputes, likely due to market volatility in recent deals.

Private equity buyers are also cautious about pursuing claims against managers who sold their shares but remain involved in the company, especially when these managers are crucial to value creation and potential recoveries are limited. Litigation typically arises over earn-outs, purchase price adjustments, and representations related to balance sheets and material adverse changes. Disputes over completion accounts are generally resolved through mechanisms in the share purchase agreement, often via a binding decision by an independent expert.

7. Takeovers

7.1 Public-to-Private

Public-to-private transactions involving private equity-backed bidders are becoming more frequent in Germany, though still not widespread.

Recent examples include the takeovers of Software AG, OHB, Aareal Bank and va-Q-tec, as well as the current takeover attempts regarding Encavis.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Material shareholding disclosure thresholds are governed by the German Securities Trading Act (*Wertpapierhandelsgesetz* WpHG). The key thresholds at which disclosure is required include 3%, 5%, 10%, 15%, 20%, 25%, 30%, 50%, and 75% of the voting rights in a publicly listed company. When a private equity-backed bidder reaches or crosses any of these thresholds, they must notify both the target company and the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – BaFin) without undue delay, within four trading days at the latest.

For private equity-backed bidders contemplating a tender offer, these disclosure obligations are particularly critical. Disclosure must account not only for shares directly held but also for those held through subsidiaries, controlled entities, or persons acting in concert. Failure to comply with these obligations can result in significant penalties and affect the validity of the voting rights, which could complicate the tender offer process.

Additionally, private equity bidders must consider the "acting in concert" rules which could trigger disclosure requirements even if individual shareholdings do not independently meet the thresholds. These rules are particularly relevant when private equity firms co-ordinate with other investors or co-investors, making timely and accurate disclosure essential.

7.3 Mandatory Offer Thresholds

If a shareholder acquires control of 30% or more of the voting rights in a publicly listed company, they are required to make a mandatory offer to all remaining shareholders. This rule is designed to protect minority shareholders by ensuring they have the opportunity to sell their shares at an adequate price in the event of a change of control.

For private equity-backed bidders, consolidation or attribution of shareholdings can be particularly relevant. Under German law, the 30% threshold considers not only shares directly held by the bidder but also those held by affiliated entities, such as other funds within the same private equity group or portfolio companies under common control. This means that if related funds or portfolio companies collectively hold 30% or more of the target company's shares, the private equity bidder may trigger the mandatory offer obligation. This attribution of shareholdings requires careful structuring and monitoring by private equity firms to avoid unintentionally crossing the threshold.

7.4 Consideration

Cash is more commonly used as consideration in tender offers, especially in transactions involving private equity-backed bidders. The preference for cash offers is driven by the certainty and simplicity they provide to shareholders. However, subject to certain restrictions, shares can also be used, particularly in strategic mergers or when the bidder aims to maintain a lower cash outflow.

The offer price must at least match the highest price paid by the bidder or any party acting in concert with the bidder for the target's shares within the last six months before the announcement of the offer. Additionally, the offer price must not be lower than the average stock market price of the target shares during the three months preceding the announcement. These rules ensure fairness to all shareholders and prevent bidders from offering prices below the market value or recent acquisition prices.

7.5 Conditions in Takeovers

Private equity-backed voluntary takeover offers typically include several common conditions, such as regulatory approvals (eg, antitrust clearance), a minimum acceptance threshold, and no material adverse change (MAC) affecting the target company. However, German law and the BaFin impose certain restrictions on the use of offer conditions to ensure fairness and transparency, and mandatory takeover offers must be unconditional (except for antitrust clearance and other mandatory regulatory approvals).

A tender offer in Germany generally cannot be conditional on the bidder obtaining financing. Instead, bidders must have secured financing for the offer (as evidenced vis-à-vis BaFin) before launching it, ensuring that the offer is fully funded and not subject to financing contingencies.

7.6 Acquiring Less Than 100%

If a private equity bidder does not obtain 100% ownership of a target, it can still seek additional governance rights to exert control over the company. These rights may include board representation, veto rights on key decisions (such as changes in business strategy, major capital expenditures, or mergers and acquisitions), and influence over the appointment of senior management. These rights are typically negotiated as part of a shareholders' agreement with other major shareholders or included in the company's articles of association.

To achieve a debt push-down into the target following a successful offer, at least 75% of the voting shares are required as this threshold allows the bidder to pass certain shareholder resolutions necessary for capital restructuring, such as the approval of a domination agreement or profit transfer agreement, which are often used to facilitate a debt push-down by enabling the target's cash flows to service the acquisition debt.

Squeeze-out mechanisms are available under German law for bidders who achieve significant ownership stakes but fall short of 100%. If the bidder reaches 95% ownership of the target's share capital, it can initiate a squeeze-out under the German stock corporation law, compelling the remaining minority shareholders to sell their shares at a fair cash compensation. If followed by a merger, 90% ownership can be sufficient.

7.7 Irrevocable Commitments

It is relatively common for bidders, including private equity-backed bidders, to seek irrevocable commitments to tender or vote from the principal shareholders of the target company. Obtaining these commitments can significantly increase the certainty of the transaction by ensuring that a substantial portion of the target's shares will be tendered or voted in favour of the offer.

The nature of these undertakings varies, but they generally require the principal shareholders to commit to tender their shares or vote in favour of the transaction, provided certain conditions are met. However, it is also common for these commitments to include a clause, which allows the shareholders to withdraw their commitment

if a superior offer is made. This ensures that the principal shareholders are not locked into the initial offer if a better proposal emerges.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentivisation of the management team is a very common feature in private equity-backed transactions. This practice aligns the interests of the management team with those of the private equity investors, motivating management to drive the company's performance and increase its value over time.

The level of equity ownership for the management team in German private equity transactions usually ranges from 3% to 20% of the company's equity. The exact size of the overall MEP as well as its allocation to individual members of management depend on factors such as the size of the deal, the seniority of the management team, and the specific role of each member within the company. In many cases, top executives may receive a larger portion of the equity, while broader equity participation plans may include mid-level management.

8.2 Management Participation

While virtual programmes and/or option solutions exist in the German market, the most frequently used and, due to German taxation, preferred method to enable management to invest into the target group in a management incentive scheme is via a purchase of shares in the target group through a joint holding vehicle (ie, indirectly); in German deals, such holding vehicle is typically a limited partnership where the managers acquire limited partnership interests (while the general partner as well as a potential warehousing entity is usually controlled by the private equity investor(s) (private equity fund) as sponsor of the management incentive scheme).

Management participation via such joint investment vehicle is commonly structured through "sweet equity" to be acquired (indirectly) by management and the "institutional strip" held by the private equity investor. Sweet equity is typically structured through the implementation of different share classes (ie, ordinary shares with unlimited profit participation rights and preference shares with profit participation rights which are limited to a predefined return or shareholder loans). While the private equity investor holds all investment tranches (ie, both classes of shares and shareholder loans) in a predefined proportion ("institutional strip"), the "sweetness" of management's equity – ie, its above-average participation in value creation, is achieved by management investing into ordinary shares in a higher proportion than the institutional strip. In a situation where the business performs well (ie, after the preference has been satisfied), this leads to the result that, for the same investment amount in the target group, management achieves higher returns on its investment than the private equity investor.

8.3 Vesting/Leaver Provisions

Time- and performance-based vesting provisions for management equity are designed to ensure that the management team remains committed to the company over a specified period. Vesting schedules often span three to five years and are usually based on the management's continued employment at the target group or, more rarely, the achievement of specific performance milestones. They are not frequently used in management equity schemes, but time-vesting can occasionally be found.

Leaver provisions are (almost) always included in management equity arrangements to address the circumstances under which a management stakeholder might exit the management incentive scheme. These provisions typically distinguish between "good leavers" and "bad leavers".

- Good leavers are those leaving due to retirement, long-term illness, permanent disability or mutually agreed departures. In the German market it can be seen that they either may have to sell their stake to the private equity investor at fair market value (usually in schemes without vesting) or they may be entitled to retain their vested stake and sometimes be able to sell their unvested stake at fair market value or, in some cases, receive a pro-rata portion based on their time of service (usually in schemes with vesting).
- Bad leavers (such as those dismissed for cause or who resign without cause or mutual agreement) often forfeit their unvested shares and may be required to sell their (vested) stake back to the private equity investor or the remaining shareholders at a discount, often at the lower of cost or fair market value at the time of their leaving.

8.4 Restrictions on Manager Shareholders

Management stakeholders typically agree to restrictive covenants such as non-compete and non-solicitation undertakings. The enforceability of these covenants is subject to certain legal limits in Germany. Non-compete agreements, for instance, must be reasonable in scope, duration, and geographic reach, with a generally accepted maximum of two years. Further, a post-contractual non-compete obligation generally requires compensation (*Karenzentschädigung*) for the affected manager during the term of the non-compete, which must amount to at least 50% of the manager's last salary. Overly broad non-compete covenants in terms of scope, geographical reach or term may be deemed unenforceable by the courts.

Restrictive covenants are often included in both equity participation agreements and employment contracts to ensure comprehensive enforceability, providing multiple legal options for enforcement if a breach occurs.

8.5 Minority Protection for Manager Shareholders

Minority protection for manager shareholders is typically very limited in German management incentive schemes. If minority protection rights are applicable, they are typically implemented through contractual agreements rather than through their equity ownership rights.

Anti-dilution protection (indirectly via their joint investment vehicle) is not a prevailing, but certainly not an uncommon, feature for management stakeholders, ensuring that their equity stake is not diluted by future equity issuances or capital increases.

Management generally does not have direct control over the exit strategy of the private equity investor. While they may be involved in discussions or consulted on the timing and nature of the exit, the ultimate decision typically lies solely with the private equity investor. However, management will often have (indirect) tag-along via its joint investment vehicle, allowing them to participate in the exit process under similar terms as the private equity investor(s).

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

Private equity funds typically exert significant control over their portfolio companies through various mechanisms.

Board Appointment Rights

Private equity funds usually secure the right to appoint one or more members to the portfolio company's board of directors or supervisory board, as applicable. This allows the fund to directly influence the strategic direction and key decisions of the company.

Reserved Matters Requiring Shareholder Approval

Private equity investors commonly negotiate reserved matters that require their explicit approval before the company can proceed. These reserved matters often include critical decisions such as changes to the company's capital structure, major acquisitions or disposals, approval of budgets and business plans, and significant hiring decisions. The scope of these matters is typically broad, ensuring that the private equity fund retains control over major decisions that could impact the value of their investment.

Information Rights

Private equity funds typically secure extensive information rights, allowing them regular access to financial reports, business updates, and other key data. These rights ensure that the fund can closely monitor the portfolio company's performance and take timely action if necessary. Information rights often include the right to receive quarterly, and annual financial statements, as well as the right to request additional information as needed.

9.2 Shareholder Liability

Particularly when dealing with a portfolio company structured as a limited liability company (GmbH) – which is the by far most commonly used legal form – the principle of separate legal personality generally protects private equity funds from direct liability for the actions of the portfolio company beyond their capital contribution.

Liability risks increase if the private equity fund is seen as exercising de facto management over the GmbH. This can happen if the fund is deeply involved in the GmbH's daily operations or strategic decisions, effectively acting as the company's manager rather than just a shareholder. In such cases, the fund could potentially be held liable for certain management actions or obligations of the GmbH under specific preconditions. However, the German Federal Court of Justice (*Bundesgerichtshof*) has so far only confirmed the liability of the de-facto management in certain cases – eg, the liability for payments following insolvency or over-indebtedness or in case of embezzlement.

Further exceptions to the principle of separate legal personality, which are typically not relevant in the context of private equity transactions, include mixing of shareholder and company assets, and withdrawal of assets without compensation that threaten the survival of the company.

10. Exits

10.1 Types of Exit

Private sales to other private equity investors or corporates are by far the most common exit processes in the German private equity market. Additionally, exits via IPOs or mergers and

demergers (ie, where the portfolio company is merged with or split into different entities) occur from time to time, but are much less common. In particular, the market for IPOs has been bad in the recent past and, thus, many planned IPOs have been postponed or cancelled.

The use of "dual-track" exit processes, where an IPO and a sale process run concurrently, is not uncommon in Germany for certain types of large-cap transactions, but very rare in other market segments. This strategy allows private equity sellers to maximise value by keeping multiple exit options open and creating competitive tension between potential buyers and public markets. "Triple-track" exit processes, in which a recapitalisation is additionally pursued as a third path, happen from time to time, but are less common and would not fall under what is seen as a "standard exit strategy" in the German private equity market.

Private equity sellers in Germany do not typically roll over or reinvest upon exit. Instead, they often seek a complete exit to return capital to their investors. However, in some cases, especially in secondary buyouts, there may be a partial reinvestment or rollover if it aligns with the strategic interests of both of the exiting and acquiring funds.

10.2 Drag and Tag Rights

Drag-along and tag-along rights are standard components of equity arrangements and play a critical role in managing shareholder dynamics during exit events. The typical drag threshold, which allows the majority shareholder to compel the minority shareholders to sell their shares, is generally around 50% of the voting shares. Tag-along rights, which protect minority shareholders by allowing them to join in the sale under the same terms as the selling majority shareholder, usually apply (in some cases pro rata) to any (including a partial) sale of shares by the majority shareholder, depending on the specific equity structure and agreements in place.

Institutional co-investors, who often hold larger stakes and have more substantial negotiating power, may secure more favourable terms within these rights. Their influence can result in tailored conditions that better align with their investment strategies, such as adjusting the thresholds or incorporating specific clauses that further protect their interests. The use of drag-along and tag-along rights in this context ensures that exits can be executed efficiently, minimising potential conflicts. In practice, however, these rights are used rarely, as the private equity investor typically aligns in advance with co-shareholders in case an exit is planned.

10.3 IPO

Exits via IPOs typically involve a lock-up period of 6 to 12 months, during which the private equity seller is restricted from selling their shares to maintain market stability. Although formal "relationship agreements" between the private equity seller and the issuer are uncommon, governance arrangements such as board representation or veto rights are often negotiated if the private equity firm retains a significant minority stake post-IPO. Timing the IPO to align with favourable market conditions is crucial, and securing cornerstone or anchor investors is a common strategy to ensure a successful offering. These investors provide stability and confidence, which can attract broader market interest.

Private equity-led IPOs in Germany often include both primary and secondary shares, allowing the company to raise new capital while enabling the private equity firm to partially exit its investment.

Trends and Developments

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Willkie Farr & Gallagher LLP is one of the few major law firms with extensive domestic and international experience in virtually every type of private equity transaction, ranging from cross-border multibillion-dollar leveraged buyouts to early-stage venture capital financings. As a recognised leader in private equity transactions, fund formation and regulatory compliance, Willkie regularly represents private equity investors, issuers and financial advisers in all aspects of domestic and international private equity transactions. Due to Willkie's longstanding representation of many international private equity and venture capital institutions, its attorneys routinely work on sophisticated private equity transactions such as leveraged buyouts, management buyouts, spin-offs, growth equity investments, venture capital financings, take-private transactions, recapitalisations and dispositions. Willkie also represents a number of institutionally backed private enterprises (including portfolio companies of the firm's private equity and venture capital fund clients) in connection with their financing, M&A and general corporate needs. Willkie's experience covers a broad cross-section of industry sectors, including manufacturing, services, finance, insurance, technology, software, retail, real estate, gaming, biotechnology, medical devices, communications and media.

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WILLKIE

While the first half of 2024 has seen an increase in M&A activity within the private equity sphere, deal volumes remain below market expectations following a subdued 2023. The ongoing conflict between Russia and Ukraine has had a persistent impact on the German market, contributing to elevated inflation throughout 2023. Additionally, the upcoming US election and geopolitical developments in China have introduced further uncertainties into the global markets.

These factors have undeniably affected the private equity industry, particularly for transactions reliant on the availability and cost of debt. Furthermore, evolving trends such as new governmental regulations like the Foreign Subsidies Regulation (FSR), a growing emphasis on ESG considerations, and challenges related to fundraising for the next generation of funds have further shaped the PE landscape in 2024.

Moderate Recovery in Deal Activity

With inflation stabilising following a rapid increase in 2023, 2024 has seen a gradual but noticeable resurgence in deal activity. This recovery can primarily be attributed to the following trends:

- While mid-cap transactions remained resilient during 2023 and served as a cornerstone of the overall M&A market, we have observed a notable increase in large-cap transactions in 2024. Many of these deals were postponed in 2023 due to market instability and a lack of accessible financing at acceptable interest rates. Law firms with expertise in both mid-cap and large-cap transactions are well-positioned to benefit disproportionately from this recovery.
- We are witnessing a rise in transactions involving corporate players, particularly in the context of carve-outs. This trend can be attributed to the strategy of large corporations, especially in economically challenging times, to focus on their core business and divest non-core units. As some of these divested businesses may have received less management attention in recent years, private equity firms see favourable entry opportunities with attractive valuations and significant potential for operational improvements.
- Finally, there has been an increase in distressed transactions. This can be attributed to several factors: The expiration of favourable financing terms secured before 2023, the ongoing crisis in Eastern Europe affecting certain businesses, and investors opting

to divest when investments no longer meet expected returns. Law firms with both private equity and restructuring expertise are well-suited to capitalise on the growing distressed deal activity.

Valuation Gap Slowly Closes

Despite the overall increase in deal activity, a gap persists between buyer and seller expectations on purchase prices. Sellers often appear anchored to pre-2023 valuations, whereas buyers have adjusted their expectations to account for the increased cost of debt. Although this gap has narrowed since its peak in 2023, there are still significant differences in expectations. On the sell-side, there is a tendency to not fully adjust business plans to reflect the current economic reality, leading to purchase price multiples that investors are often unwilling to pay due to a lack of confidence in the business plan's assumptions.

In the market, several approaches are being employed to bridge the valuation gap and facilitate deals, even amidst differing expectations. These approaches have largely remained consistent since 2023 and often involve one or more of the following legal mechanisms:

- Earn-out provisions: These provisions tie a portion of the purchase price to the target company's post-closing performance. Given the potential for disputes and the typical operational and structural changes (including add-ons) in private equity transactions, there is a clear trend toward earn-outs based on the investor's exit proceeds, rather than on specific financial metrics at a given point in time.
- Vendor loans and other deferred payment mechanisms: While, from a PE buyer's perspective, a vendor loan is arguably the ideal solution to replace expensive or unavailable debt financing, it does not help to fully close the gap in terms of purchase price. Also, vendor loans tend to be the least attractive option from a seller's perspective, and the interest rates requested by sellers (in line with the development on the debt markets) have significantly increased. Furthermore, sellers increasingly demand vendor loan documentation with lender protections, complexity, and length approaching that of traditional debt financing. The days of simple purchase price deferrals with interest payments (ie, a short clause in the SPA) appear to be over.
- Rollovers or reinvestments of parts of the purchase price: Traditionally, sellers seeking to participate in the target's anticipated growth post-acquisition requested reinvestments. However, an increasing number of investors are now utilising reinvestments as a means to reduce acquisition costs. Accordingly, with more investments not being 100% takeovers, well-drafted shareholders' agreements (and the exit rights of the parties thereunder) are playing a more prominent role in current deals.

Comeback of Large-Cap Transactions

As indicated above, there appears to be a moderate recovery in the large-cap transactions market. There are a number of reasons to remain optimistic in this regard in 2024:

- While interest rates are still significantly higher than in the pre-2023 bull market, debt financing appears to have stabilised during the past months – ie, while debt was in many cases not available at all during 2023 due to market uncertainty and financing sources' reluctance to take risks, financing is generally available again, only at higher rates.

- New forms of financing (including a stronger focus on private debt or seller financing) have become accepted and used more broadly in the market. While, in 2023, a number of large-cap transactions eventually failed due to a lack of traditional bank financing being available and market participants' reluctance to try new ways, using financing beyond traditional bank financing has become increasingly customary for "big tickets" too.
- A significant number of large-cap funds still sit on huge amounts of "dry powder". With limited investment opportunities materialising in 2023, the pressure to deploy this capital is immense, potentially leading to an uptick in successful deals.
- The number of large-cap corporate carve-outs has significantly increased, offering opportunities for PEs.
- Fund-to-Fund transactions remain on track as in the year 2023.

The above trends are expected to continue, therefore large-cap transaction activity is likely to further catch up with mid-cap during 2024.

Continued Focus on Portfolio Work

The heightened emphasis on portfolio work by PE firms has persisted in 2024. With financing costs still relatively high and buyers hesitant to pay pre-2023 multiples, PE firms must diligently prepare their portfolio companies for exits. This involves demonstrating both increased EBITDA through operational improvements and adherence to ESG and compliance standards, which are now expected by buyers and can even be a deciding factor in uncertain situations. Both these trends necessitate significant "hands-on" involvement with portfolio companies. While this process may take time, it is expected to ultimately result in a greater number of attractive targets becoming available in the future.

More Distressed Deals

The convergence of factors such as the expiration of pre-inflation financing lines for many businesses and a more challenging economic climate riddled with political and commercial uncertainties has unsurprisingly led to a rise in distressed deals. From an investor's standpoint, these deals can remain lucrative, even becoming more attractive in a high-interest rate environment due to the minimal or even absent positive purchase price requiring financing through equity or debt.

This trend is evident in the establishment of an increasing number of specialised turnaround or special situations funds, with many choosing Munich as their German base. While this development intensifies competition for attractive distressed targets, which have been dominated by a few larger specialised players in recent years, it also presents an opportunity for law firms with strong experience in both the PE and restructuring sectors to differentiate themselves.

More Regulation

Since the last financial crisis, it is undeniable that the era of laissez-faire transactions is over, with increased governmental intervention becoming the norm. This trend has been further fuelled by the perceived rise in investment activity from non-democratic states, particularly China, in Western countries, including Germany.

While heightened scrutiny on regulatory "classics" like merger control and FDI has been evident for years, new regulatory frameworks have recently emerged, setting a new standard in the transaction industry. The most notable is the Foreign Subsidies Regulation (FSR), which came into force in 2023 and introduces new control mechanisms for investments by entities that have received non-EU subsidies.

The FSR holds particular significance for larger mid-cap and large-cap deals, applying to EU-based target groups with a total EU turnover of at least EUR500 million and a relevant subsidies threshold exceeding EUR50 million in the three years preceding a transaction. Although a definitive administrative practice regarding FSR filing requirements has yet to be established, the broad interpretation of "subsidy" has led to numerous filings, even from PE buyers, in the past 12 months.

While it may seem unlikely that PE buyers themselves would be considered recipients of state subsidies, there is a significant risk that investments into their limited partners, especially by non-EU sovereign wealth funds, could be classified as "subsidies" under the FSR. Until a clear administrative practice to the contrary is established, we anticipate that FSR assessments, and potentially clearance, will become standard in transaction-related regulatory matters, including customary closing conditions.

Continued Importance of ESG

As in 2023, ESG and related topics remain an important and growing factor in the PE industry. While creating a sustainable carbon footprint has been an important image factor for quite a while, other ESG topics (such as supply chain management, overall sustainability, employee health, etc) have also become increasingly relevant in the investment decisions and daily work of private equity. From a legal practitioner's perspective, this means that targets are subjected to more thorough ESG scrutiny during due diligence. On the other hand, not all targets qualify as suitable targets under the funds' investment guidelines any longer. The growing awareness of ESG-related topics has even led to an increase in the number of funds specifically dedicated to ESG matters – ie, impact funds. We expect law firms with proven capabilities in compliance and ESG matters to benefit from this long-term trend.

Moreover, diversity is assuming an increasingly vital role in many investment processes. While this partly stems from image and communications considerations, we also observe a growing conviction among investors that diversity in teams and opinions often leads to superior work outcomes. Consequently, investors are placing greater emphasis on working with a diverse range of individuals within their teams, portfolio companies, and adviser teams.

More Buyer-Friendly SPAs

As the overall transactions climate has shifted from a seller's market to a buyer's market, SPAs have become increasingly buyer-friendly.

One notable change is the shift from locked-box purchase price mechanisms toward closing accounts. This mechanism, which does not necessitate audited accounts from a past date, is typically more favourable to buyers and aligns with the current market dynamics. Furthermore, closing accounts are particularly preferred in carve-out scenarios, and the growing trend towards corporate carve-outs in the past year has further contributed to their resurgence in the German market.

Additionally, we have observed a more frequent use of various types of MAC clauses in the past year. While MACs were virtually non-existent in the German market before 2023, they are now more commonly included or at least requested. Unsurprisingly, the utilisation and perceived need for a MAC clause directly correlate with the degree of economic and political uncertainty in the market.

Finally, instances where sellers ultimately assumed liability in insured deals for certain representations and warranties that the W&I insurance refused to cover have increased. While such a request in the pre-2023 seller's market would have likely deterred bidders, sellers now appear more willing to negotiate critical SPA items individually, as long as the overall deal remains commercially attractive. Consequently, we anticipate greater pushback and negotiation between parties in the future regarding legal matters that were once considered "market standard" and readily accepted.

Fundraising Issues and Shift to Fund-to-Fund Transactions

In 2024, fundraising for the next generation of funds has proven more challenging than in previous years. Several factors contribute to this trend. The short-term track record of many funds has been moderate, as numerous planned exits were postponed due to the overall weak transactions market. Additionally, many funds still hold substantial amounts of "dry powder" due to a lack of well-priced, quality opportunities. Although recent deal activity has increased, raising new funds remains difficult in a market with still too few opportunities and simultaneously too much capital (with the exception of specific sectors like turnaround funds, which benefit from the current market conditions).

Consequently, many funds have been willing to make concessions to investors, such as offering discounts on fees for large investors or providing opportunities for co-investments in selected deals. This demonstrates the increasingly competitive landscape for fundraising in the private equity industry.

Furthermore, the existing trend of rolling good investments into next-generation funds or dedicated continuation vehicles has persisted in 2024. Fund-to-fund transactions, once rare and mainly used when a target was not ready for an exit at the end of a fund's lifespan, have become an attractive option for private equity firms. This allows them to realise profits for existing investors while deploying some of their "dry powder" into "new" investments they remain confident in, especially given the scarcity of promising targets and the valuation gap between buyers and sellers. We do not foresee a significant change in this trend but rather expect the number of such deals to stabilise at a (significant) level in the long term.

Summary

2024 is showing promising signs of being a turnaround year in the previously sluggish transactions market. The resilient mid-cap segment has been the industry's foundation over the past year. Now, with stabilising interest rates, reliable debt availability, and increased corporate carve-out transactions, the outlook is also brightening for large-cap deals. We have witnessed a moderate revival of large transactions since the start of the year, and we remain optimistic about further deals materialising in the second half.

Concurrently, lingering uncertainties and the aftermath of recent crises have fuelled activity in the distressed deal space. Additionally, persistent valuation gaps and a scarcity of attractive new targets have driven the trend toward fund-to-fund transactions.

While overall deal activity remains below initial expectations for 2024, the upward trend across virtually all segments is undeniable. We anticipate that law firms with a broad range of transaction skills, serving both mid-cap and large-cap deals, and possessing proven capabilities in the restructuring segment will be best positioned to capitalise on the current market developments.

INDIA

Law and Practice

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Jerome Merchant + Partners is a corporate commercial law firm based primarily out of Mumbai, with additional offices in Delhi and London. The firm's private equity practice is headed by Sameer Sibal. It advises on investments, buy-outs, exits, portfolio restructurings and secondaries. The firm's private equity practice is complimented by its M&A, banking and finance, capital market and disputes practices to provide a fully integrated service across all capital stages. The firm completed more than 72 transactions in the PE space and over 11 transactions in the M&A space in 2022.

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JEROME MERCHANT + PARTNERS

1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

Recent Trends in PE and M&A Activities

As per publicly available reports, the value of private equity transactions was at USD29.7 billion, which declined by 38% in 2023 compared to the record of USD47.6 billion investments in 2022. In 2023, the investment value dropped by 38% and the volume of investments was 44.5% lower compared to 2022. Having said this, 2023 witnessed historic opportunities when it comes to public M&A, both in terms of the quantum of control deals as well as initiatives of SEBI. The public M&A market witnessed a total of 85 open offers in 2023, where the aggregate deal value was approximately INR105 billion, with an open offer by Proximus group to acquire Route Mobile Limited for INR26 billion being one of the largest cross-border control deals in the communication platform space in India.

Despite the slowdown in 2023, domestic deal volume gained momentum in 2024, as private equity firms invested over USD6.2 billion in Indian companies during the first quarter of 2024. Although investment value in Q1 2024 was lower as compared to the same quarter in 2023, overall disclosed deal volume as per public information, in the first quarter of 2024, was marginally higher.

The first quarter of 2024 saw a staggering 354.5% increase in PE exits compared to Q1 2023. As per publicly available information, this translates to a jump from just 11 exits in the previous year's first quarter to a robust 50 exits in Q1 2024. There was also a sizeable increase in the overall exit value of deals in this period.

Overall inbound investment activity in India remained positive in the first half of 2024, and in the view of the authors, given the market trend, it is expected that the second half of the year will witness resurgence in deal activity (which of course is subject to any downturn for geo-political issues which may impact the overall economy).

1.2 Market Activity and Impact of Macro-Economic Factors

Sectors Dominating the PE and M&A Landscape

The technology sector continued to be a prominent player in private equity and M&A deals in India, with highest deal volume and deal value in 2023. Tech companies topped the industry chart with some notable investments such as infusion of USD500 million each in Quest Global by Carlyle and Lenskart by Abu Dhabi Investment Authority. Other noteworthy deals included the USD450 million investment in IBS Software by General Atlantic.

In 2024, TMT has also seen a significant rise in deal activity, particularly in areas like digitalisation and streaming services, with the high-profile Reliance-Disney merger. Telecoms emerged as the top industry for Q1 2024, led by the USD2 billion acquisition of ATC-Brookfield. Having said this, traction for funding of technology companies continued in Q1 2024, which was led by the USD150 million funding in Indo-US contact centre software maker Kore.ai. The second quarter witnessed IT companies attracting investments worth USD3.6 billion, with notable investments in Altimetrik and Zepto.

The healthcare and pharma sectors also witnessed the largest investment in 2023 in Manipal Hospitals by Temasek and TPG Capital of USD2.4 billion. This was followed by the USD732 million buyout of Indira IVF by Baring Asia and USD700 million buyout of Care Hospitals by

Blackstone. Strong traction in this sector continued in 2024, with investments worth USD2.1 billion in the second quarter of 2024, led by the USD840 million acquisition of medical devices firm Healthium Medtech.

Financial services witnessed a 45% decline in deal value in 2023, however, deal volume rose by 23%. The finance industry attracted investments worth USD3.4 billion, led by the USD1.3 billion buyout of education loans provider HDFC Credila Financial Services by Baring Asia and ChrysCapital. Further, 2023 saw the highest number of open offers being made in the financial services sector, with a total number of 19 open offers made in target companies involved in the financial services sector. The financial sector remained strong in Q2 2024 with deals such as the USD554 million acquisition of Shriram Housing Finance by Warburg Pincus.

Factors Impacting PE/M&A Activities

Technology has seen the highest growth in cross-border M&A activity owing to increasing supply and demand, with Artificial intelligence (AI) emerging as a popular target for deal-makers around the world.

While higher interest rates and macro-economic factors have presented challenges, the first quarter of 2024 suggests that PE firms are finding solutions to navigate the new environment. The authors have observed continued focus on growth opportunities, selectivity in investments and a rise in smaller and mid-sized deals.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

The key developments which have brought changes to the regulatory landscape and influenced investment decisions are set out below.

Reserve Bank of India (RBI)

Scale-based regulations

On 19 October 2023, RBI released the Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023, consolidating the Master Directions governing systemically important and non-systemically important NBFCs, as well as relevant provisions from the Scale Based Regulatory (SBR) Framework and periodic circulars of RBI, into a single master direction. This new framework has replaced the previous distinction between systemically important and non-systemically important NBFCs, now categorisng all NBFCs into four distinct categories.

- base layer (NBFC-BL), which includes non-deposit taking NBFCs with an asset size of less than INR1,000 crore, NBFC P2P, NOFHCs, NBFCs not availing public funds and not having any customer interface;
- middle layer (NBFC-ML), which includes all deposit-taking NBFCs, non-deposit taking NBFCs with asset size of INR1,000 crore and more, HFCs, IDF NBFCs;
- upper layer (NBFC-UL), which includes NBFCs which are specifically identified by the RBI; and
- top layer (NBFC-TL), which will include NBFCs which the RBI shifts from the upper layer to the top layer if such NBFCs have potential systemic risk.

The SBR framework focuses on improving risk management, governance, and transparency across the sector.

Restrictions on investments in AIFs

On 19 December 2023, the Reserve Bank of India issued a circular prohibiting all regulated banks, financial institutions, and non-banking financial companies (collectively referred to as "Regulated Entities" or "REs") from investing in Alternative Investment Funds (AIFs) that have downstream investments in a "debtor company" of these RE.

The RBI's clarification to the 19 December 2023 circular, issued on 27 March 2024, states that the restriction does not apply to investments in the equity shares of debtor companies. However, other investment types, such as hybrid instruments, remain restricted. According to the 19 December 2023 circular, regulated entities unable to divest their investments within the specified timeframe must allocate funds to cover 100% of the investment's value. The recent clarification adjusts this provision to apply only to the portion of the investment directly related to the debtor company, not the entire investment. Additionally, it clarifies that investments made by regulated entities in AIFs through intermediaries, such as fund of funds or mutual funds, are not subject to these restrictions.

Companies Act, 2013

On 27 October 2023, the Ministry of Corporate Affairs (MCA) vide notification came up with the two major amendments in relation to limited liability partnership (LLP) and companies.

- Declaration regarding beneficial interest in LLP – the concept of registered partner and beneficial partner has been introduced vide the aforesaid notification and registered partners and beneficial partners are required to disclose their interest in Form 4B and Form 4C within 30 days of acquiring such control in the LLP.
- Identification of designated person of the company – under Companies Act, 2013, beneficial owners were liable to disclose the beneficial interest; however, as per the amendment, companies are required to appoint a designated person of the company who shall be responsible for disclosures made by beneficial owners for such company. Such designated person could be either a company secretary or key managerial personnel or a director.

Digital Personal Protection Act, 2023 (DPDPA)

The DPDPA, 2023, which aims to amend India's current data protection laws, received presidential assent on 11 August 2023. However, its effective date has not yet been announced. This new law broadens the scope of protection from "sensitive personal data" under the previous Information Technology (Reasonable Security Practices and Procedures and Sensitive Personal Data or Information) Rules, 2011, to include "personal data".

Competition law

On 6 March 2024, CCI enacted the CCI (Settlement) Regulations on August 24 (the "Settlement Regulations"). Section 48A of the Competition (Amendment) Act, 2023 allows an enterprise under investigation to seek settlement with CCI. The Settlement Regulations outline the process for settlement proceedings by providing a quicker resolution of competition-related disputes, thereby reducing the legal uncertainties and risks.

In addition to the foregoing, the Ministry of Corporate Affairs revised the asset and turno-

ver thresholds for transactions requiring CCI approval. Prior to the amendment, transactions were exempted from CCI approval, if the asset threshold was INR350 crore and turnover is INR1,000 crore. After the amendment, the revised thresholds are INR450 crore for assets and INR1,250 crore for turnover.

These CCI amendments have been poised to simplify regulatory requirements for private equity investments in India by potentially exempting more transactions from CCI scrutiny, making India a more attractive destination for private equity investments.

Abolition of Angel Tax

In the budget presented by the finance minister for financial year (FY) 2024–25 on 23 July 2024, the government abolished Angel Tax – ie, tax on consideration received by Indian companies for issuance of equity shares above fair market value. This is a significant move in the right direction for companies raising capital, as the abolition of this tax alleviates the ability for the company to be taxed when it is issuing securities to investors at a premium to the fair value.

Securities Exchange Board of India (SEBI)

SEBI AML amendments

As per the SEBI circular issued on 31 July 2023, an AIF, at the time of onboarding a foreign investor, is required to ensure that such foreign investor or its underlying investors contributing 25% or more in the corpus of the investor or identified on the basis of control, is not a person(s) mentioned in the Sanctions List notified from time to time by the United Nations Security Council and is not a resident in the country identified in the public statement of Financial Action Task Force.

On 11 January 2024, SEBI issued a circular revising the aforementioned threshold from 25% ownership to beneficial owner as defined under sub-rule (3) of Rule 9 of the Prevention of Money-laundering (Maintenance of Records) Rules, 2005 (the "AML Rules"). The threshold under the AML Rules for determining beneficial owners of (i) companies is 10% of the shares, capital, or profits; (ii) partnership firms is 10% of the capital or profits; and (iii) trusts is 10% of the interest in the trust.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

The regulatory environment for private equity funds and transactions in India is overseen by various key regulators, each playing a crucial role in ensuring compliance and investor protection. In recent times, there have been notable developments in M&A regulations and a growing emphasis on investing in AI, environmental, social, and governance (ESG) compliance.

Primary Regulators for Private Equity Funds

The Reserve Bank of India (RBI) is the key regulatory authority for foreign direct investment (FDI) in India. The Foreign Exchange Management Act, 1999 (FEMA), consolidated FDI Policy Circular of 2020, and FEMA (Non-Debt Instruments) Rules, 2019, govern foreign investment transactions. The foreign exchange regulations also distinguish FDI investments from foreign portfolio investments (FPIs). FPI investors are from offshore entities, hold an FPI registration, and invest in India through equity instruments where such investment is less than 10% of a listed Indian company.

SEBI is the primary regulatory body governing private equity funds in India. SEBI's oversight extends to venture capital, private equity funds,

and pooling vehicles operating as Alternative Investment Funds (AIFs). The SEBI (Alternative Investment Funds) Regulations, 2012, as amended, lay down the regulatory framework for AIFs, prescribing investment restrictions and conditions for different categories of funds to safeguard investors and manage risks.

Some of the relevant provisions for FDI include the following.

- Automatic route and approval route. Approval requirements for foreign investments in India depend upon the sector in which the company is conducting business. Most sectors, including information technology and manufacturing, fall under the automatic route, where no government approval is required. Certain sensitive sectors continue to require governmental approval such as retail trading, broadcasting, and sensitive defence and energy sectors.
- Sector-specific restrictions. Under the automatic route, different business sectors have varying investment thresholds and conditions for foreign investment. Therefore, any deviation from such thresholds or conditions would trigger an approval requirement.
- Pricing guidelines and reporting requirements. Foreign investors must comply with the pricing guidelines, valuation norms and reporting obligations such as inward remittances, KYC, and providing investment details to RBI under FEMA Laws.

Obtaining regulatory approvals and navigating lengthy disclosure requirements may present challenges.

Regulatory Issues in M&A Laws

Mergers and acquisitions in India are governed by a framework that includes the Companies Act, 2013, Competition Act, 2002, FEMA laws, and SEBI Act, 1992, along with rules and regulations.

Key regulators for a merger differ based on the type of company involved. For private and unlisted public companies, the National Company Law Tribunal (NCLT) serves as the primary regulator. For public listed companies, in addition to the NCLT, SEBI acts as a regulatory authority.

Noteworthy provisions in merger control include the following.

- Merger approval. Companies seeking to merge must apply to the NCLT. Among other conditions and requirements, a majority in number, representing three-quarters in value of the creditors or shareholders present and voting, need to agree to the merger. Thereafter, once sanctioned by the NCLT, it is binding on all the creditors and shareholders of the company.
- Fast-track mergers. Small companies and holdings, or wholly-owned subsidiary companies, may utilise this route, streamlining the approval process. This merger doesn't require approval of the NCLT, unless central government directs the NCLT to take up this merger.
- Cross-border mergers. Mergers between Indian and foreign entities have been facilitated subject to satisfaction of certain conditions set out under the Companies Act, 2013 and FEMA regulations.
- Listed company mergers. SEBI's Takeover Code may apply, requiring an open offer to acquire at least 26% voting capital. Further, under Listing Regulations, any listed company involved in the scheme of the merger must seek a no objection certificate from the stock exchange prior to filing with the NCLT.

Regulatory Issues in ESG Compliance

In recent years, ESG considerations have gained prominence in private equity investors' value creation and exit plans. India does not have a specific regulatory framework for ESG; instead, the regulatory framework related to ESG comes under various pieces of legislation, including: the Factories Act, 1948; Environment Protection Act, 1986; Air (Prevention and Control of Pollution) Act, 1981; Water (Prevention and Control of Pollution) Act, 1974; Hazardous Waste (Management, Handling and Transboundary Movement) Rules, 2016; Companies Act, 2013; SEBI Act; Prevention of Money Laundering Act, 2002; Prevention of Corruption Act, 1988; and laws with respect to the payment of minimum wage, bonus, gratuity, welfare activities, health and safety, etc. Various aspects of ESG are covered under these pieces of legislation in a fragmented manner.

Some of the recent developments include the following.

- SEBI – from FY 2024–25 onwards, disclosures as per BRSR core in the annual report are required for value chain partners of the top 250 listed entities by market capitalisation on a comply-or-explain basis.
- Cybersecurity and data privacy – mandatory disclosure of data breaches and compliance with the Digital Personal Data Protection Act, 2023, which includes penalties for data protection failures.
- RBI – RBI published a draft disclosure framework on Climate-related Financial Risks, 2024, to improve the consistency and comparability of climate-related disclosures in India. The framework mandates the Indian financial institutions to incorporate climate-related assessments into their mainstream compliance.

4. Due Diligence

4.1 General Information

The diligence exercise plays a crucial role in private equity transactions by providing a comprehensive assessment of a company's legal standing, identifying potential risks, liabilities, and other pertinent issues that may impact the deal. A legal due diligence is the foundational step of any investment decision in PE and M&A transactions. The level of legal due diligence may vary based on the nature of each transaction and the intricacies involved.

Typically, a detailed legal due diligence questionnaire is prepared to ensure a meticulous investigation of the target company. This largely involves a thorough examination of relevant legal documents, understanding the corporate structure of the entities involved, assessing compliance with various regulatory requirements and identifying any pending or potential claims involved.

Key Areas of Focus for a Legal Due Diligence in Private Equity Transactions

The legal due diligence process in private equity transactions centres on reviewing the following key aspects.

- Directorship and shareholding. Examination of the terms and conditions attached to issued securities, directorship details, and the shareholding structure and analysis of corporate governance practices.
- Statutory and regulatory compliance. Delving into licences, permits, approvals, and industry-specific statutory compliance undertaken by the target company.
- Affiliates. Scrutinisation of the details of group companies, holding entities, subsidiaries,

and associate companies to assess potential implications on the transaction.

- Inward and outward remittance. Inquiries are made into FDI or outward direct investments (ODI) related to the target company.
- Intellectual property rights. Verification of ownership of patents, trade marks, copyrights, industrial designs, and other proprietary rights owned or used by the company, as well as rights granted to third parties.
- Books of accounts. Examination of financial statements, loan details (both availed and provided), and open charges on the target company to understand its financial health.
- Ongoing litigation. Identification of pending and threatened litigation, arbitration, or regulatory actions involving directors or promoters that may impact the target company as well as assessment of potential liabilities and litigation risks.
- Contracts, commercial agreements. A careful review of contracts and commercial agreements is undertaken to assess contractual obligations, including change in control provisions and key contractual terms such as termination clauses, indemnities, and warranties.
- Employment. Labour law compliances as well as agreement with employees are reviewed as a part of the diligence exercise.
- Data Protection. Evaluation of compliance with data protection laws and assessment of data security measures.

Generally, the following issues, if they arise, are material for a private equity investor to focus on.

- Legal proceedings with substantial risks against the target company or its promoters.
- Statutory restrictions that may hinder the execution of the proposed transaction.
- Statutory non-compliance which may result in material risks to the company or its business model.
- Matters related to the core management, control, or ownership of the target company.
- Hidden contingencies or undisclosed commitments that may pertain to trade secrets or intellectual capital.
- Corporate governance issues that need to be addressed.

Recent Trends and Lessons From Start-Ups

Recent years have witnessed various start-ups making headlines due to corporate misgovernance and financial discrepancies. These instances have raised questions on the adequacy of information or scrutiny for such governance issues.

In order to address such pitfalls, founders and investors have placed increased emphasis on corporate governance in their due diligence process. Furthermore, robust internal controls, transparent financial reporting, and adherence to regulatory guidelines are being adopted, thereby ensuring a more secure investment landscape for private equity transactions.

4.2 Vendor Due Diligence

The use of a vendor due diligence (VDD) is a significant feature in certain company-driven or competitive deals. VDD involves the target company providing essential information to potential buyers, including details about its business, financial condition and legal standing. It aligns with the goal of maximising value for investors as this information is analysed by prospective buyers to assess the associated risks and safeguard their interests post-closing.

Scope and Documents in VDD

In VDD, the target company's representatives are required to prepare a comprehensive VDD report, which serves as the primary source of information for potential buyers. The report highlights key aspects of the target company, enabling buyers to make informed decisions regarding the transaction. Alongside the VDD report, buyers are also provided with key documents to supplement the findings stated therein. The scope of these documents is typically limited to additional information requested by buyers to gain clarity on the issues highlighted in the VDD report.

Reliance on VDD Reports

Unlike some other jurisdictions, in India, sell-side advisers or target companies do not typically provide reliance on the VDD reports. While they can serve as a helpful resource for buyers, it is essential for investors to independently request material diligence documents and have discussions with the target company to address any key issues referenced in the VDD report.

Access to UPSI vis-à-vis VDD

In the case of listed entities, disclosure of unpublished price sensitive information is restricted unless:

- the transaction triggers an open offer and the board of the target company is of the informed opinion that sharing such information is in the best interests of such target company; and
- the transaction does not trigger an open offer, the board of the target company is of the informed opinion that sharing such information is in the best interests of such target company, and the information that constitutes unpublished price sensitive information is disclosed at least two trading days prior to the proposed transaction.

5. Structure of Transactions

5.1 Structure of the Acquisition

Private equity investments as well as acquisitions are predominantly structured through the primary or the secondary route, or a combination of both. Private equity funds typically enter into share subscription or share purchase agreements for subscribing into new shares or purchasing the existing shares of the target company, in the form of equity or preferred stocks or a mix of equity and preferred capital, for cash or non-cash considerations paid on an immediate or deferred basis. With respect to foreign private equity funds, hybrid instruments are not customarily contemplated as an investment instrument for FDI in India. FDI in India is permissible through equity shares, compulsorily convertible shares, compulsorily convertible debentures and share warrants, as opposed to instruments which are optionally convertible or are non-convertible, which are considered as external commercial borrowings and are governed by separate regulations.

Further, a court-approved scheme is preferred in scenarios for a merger of companies or where a company opts for reconstruction of its capital and its assets with the approval of the court and its shareholders prior to the sale/acquisition.

5.2 Structure of the Buyer

In India, private equity-backed buyers conventionally acquire the target directly rather than establishing a separate SPV for pooling of funds. Having said this, it would be more customary for offshore acquisitions by Indian companies

to establish an offshore SPV to pool funds or raise debt.

5.3 Funding Structure of Private Equity Transactions

Financing of PE Acquisitions

Private equity transactions are traditionally financed through a combination of debt and equity. The details of such a fusion of equity and debt depends on a number of factors such as the size of the deal, stage of the target company and risk profile of the investment. The equity component is infused by institutional investors and a pool of private capital deposited in the private equity fund, which is used to pay for the equity investment. There is also an increasing tendency towards infusion of capital by high net worth individuals in acquisition transactions involving private equity funds in India, where high net worth individuals invest directly in the target companies, invest through private equity funds or co-invest with a private equity fund.

Debt Financing

The debt component is conventionally provided by financial institutions or private debt funds. However, acquisition financing is generally not permitted by Indian banks, except in certain limited circumstances. Non-banking finance companies (NBFC), alternate investment funds and mutual funds may provide financing for acquisition of shares in India, provided they meet prudential and concentration norms. Non-convertible debentures (NCDs) are another method of debt financing, however, the extent of regulation of NCDs depends on their being listed, unlisted, publicly or privately placed. Privately placed unlisted NCDs are a popular form of debt financing for foreign private equity investors. NCDs are offered and sold directly to a select group of investors and have a pre-determined short-term tenure. Furthermore, in case of an investment by a foreign owned and controlled Indian company, such Indian entity is not permitted to use borrowed funds for the purpose of making downstream investment in India, which is considered as an indirect foreign investment.

5.4 Multiple Investors

There is an emerging trend within private equity consortium culture that India has witnessed in recent years. Private equity funds typically collaborate with other private equity funds or corporates to invest in target companies as a consortium. Co-investments involving the acquisition of passive stakes by limited partners along with the private equity funds that are already investors in the target companies are also significantly evidenced in the private equity landscape. In some deals, high net worth individuals may also collaborate with each other in a similar manner and invest as a consortium. The consortium brings to the table the complementary skills, expertise, resources and networks of different private equity funds and investors, which in turn are instrumental in supporting upcoming business and help to yield maximum profits on their investment.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Private equity transactions employ various consideration mechanisms, each tailored to meet the specific needs of the parties involved. These mechanisms include fixed price with or without locked-box, completion accounts, and share swaps. Additionally, while deferred consideration structures feature in private equity deals, transactions involving non-resident or foreign parties must comply with foreign exchange regulations when incorporating deferred consideration.

Consideration Mechanisms in Private Equity Transactions

- Fixed price – in this structure, the parties agree upon a fixed consideration amount that remains unchanged throughout the transaction.
- Completion accounts – under this mechanism, the consideration is determined based on the financial statements of the target company as of a specified date. This provides flexibility for adjustments based on the audited or verified value of the target, ensuring a fair and accurate valuation.
- Share swaps – in a share swap, the acquirer purchases the shares of the target company in exchange for allotting its own shares to the shareholders of the target company. This mechanism enables an exchange of ownership and alignment of interests between the acquirer and the target company's shareholders.

In the event non-resident or foreign parties are involved, the parties must further comply with foreign exchange regulations, including the pricing norms thereunder.

Deferred Consideration in Private Equity Transactions

If non-resident or foreign parties are involved, these transactions must adhere to specific foreign exchange regulations.

- Limitation on deferred consideration – for secondary transactions with non-resident parties, the deferred consideration component should not exceed 25% of the total consideration.
- Timeframe for payment – the payment of deferred consideration for a secondary transaction must occur within a period of 18 months from the execution date of the transfer/secondary agreement.
- Pricing guidelines – the deferred consideration must comply with the pricing guidelines on fair market value prescribed under the foreign exchange regulations.

In addition, the parties involved in private equity transactions take various protective measures to safeguard their interests. These protections may include indemnity holdbacks and escrow arrangements, which are further subject to certain limitations prescribed under the foreign exchange regulations in cases involving non-resident/foreign parties. The impact of private equity fund involvement on these protections may differ compared to a corporate seller or buyer.

6.2 Locked-Box Consideration Structures

Under certain cases, reverse charge interest may be charged on any leakage that may occur during the locked-box period. Typically, leakages can be in the form of transfer/disposal of assets, write off of any receivables, dividends. Having said this, there are certain leakages which are permitted, such as remuneration to the employees in the ordinary course of business and general administrative and management costs and any other leakages agreed between the parties.

6.3 Dispute Resolution for Consideration Structures

The majority of private equity transactions have institutional form of arbitration as the preferred mode of dispute resolution. The choice of dispute resolution does not really vary based on the consideration structure used under the transaction. However, the computation of the consideration amount which is in dispute among the parties is typically ascertained by an expert cus-

tomarily from amongst the Big Four accounting firms.

Furthermore, there has been a general tread of parties adopting arbitration administered by the Singapore International Arbitration Centre with the seat of law being in India or Singapore (which is a negotiated point based on each party's preference).

6.4 Conditionality in Acquisition Documentation

Private equity transactions are typically subject to:

- completion of all pre-closing conditions to the satisfaction of the purchaser(s);
- consent or intimation requirement from the lenders or financial institutions;
- third-party consents under any contractual arrangements which a company may have;
- any change of control intimation or consent requirement under any material contracts; and
- board as well as shareholders' approval as arising or set out under the applicable law, existing shareholders' agreement or any agreement governing the rights and obligations of a company's shareholders and the charter documents. In addition, documentation will include key diligence findings as conditions precedent to closing the transaction, in order to ensure that the target company addresses material issues highlighted by the investor.

Furthermore, the concept of "material adverse change" (MAC) is quite common under private equity transactions in India. MAC accords the contractual protection to the acquirer to terminate the agreement or not proceed towards funding for events which effect the validity of the transaction documents or which have an adverse impact on the financials or business of the company. The concept as well as the definition is similar to that as adopted in the UK or Singapore.

6.5 "Hell or High Water" Undertakings

Hell or high water conditions typically depend on a case-by-case basis in private equity transactions in India. There are certain sectors under foreign investment conditions wherein foreign investment above a certain threshold requires regulatory approvals and certain conditions to be followed. Similarly, there are certain monetary thresholds prescribed under the merger control regime in India for which parties are required to take regulatory approvals.

Therefore, depending upon the sectors under foreign investment and the monetary thresholds under the merger control, hell or high water undertaking is negotiated under a transaction. However, as a general rule, depending upon the applicable rules and regulations, the hell or high water conditions are commonly undertaken on a "reasonable" or "best efforts" basis by the parties involved.

6.6 Break Fees

In India, break fees as well as reverse break fees are not common and typically depend contractually on a deal-to-deal basis.

From a legal perspective, there are no specific laws which govern the trigger and volume of such break fees and it contractually depends upon the parties involved. However, an overarching principle is that such break fees should not be punitive in nature and are captured as "liquidated damages". Having said this, remittance of break fees from an Indian counterparty to an offshore party may require regulatory approvals.

6.7 Termination Rights in Acquisition Documentation

Under an acquisition agreement, both the buyer as well as the seller are provided with the right to mutually terminate the agreement, if so decided and agreed and in case the transaction is not consummated and closed within the long-stop date.

However, there are certain additional protections accorded to the buyer wherein buyer can unilaterally terminate the agreement in case of:

- breach of representations and warranties or of any material covenants provided by the seller;
- fraud, wilful misconduct or gross negligence;
- occurrence of MAC; and
- failure to complete any conditions precedent (whether regulatory, contractual or diligence related) to the transaction on or prior to a long-stop date.

Typically, a long-stop date is negotiated between the parties depending upon the time required for the completion of pre-funding obligations by both the parties. However, subject to the nature of conditions precedent, a period of 45–60 days from the signing of the documents can be considered a reasonable timeline for the same. If any specific governmental or anti-trust approvals are required, then this time period will need to be adjusted.

6.8 Allocation of Risk

The overall allocation of risk differs in a deal where the seller or buyer is a corporate or an institutional fund. In instances where institutional funds are sellers, the representations and warranties provided to the counter party are limited and primarily restricted to authority, title, tax and capacity. Furthermore, the indemnity obligation is also limited (capped in amount and time) as opposed to an open-end liability in case of company and promoters or founders.

6.9 Warranty and Indemnity Protection

Private equity sellers customarily provide only fundamental warranties limited to title to shares, tax, authority and capacity. Furthermore, depending upon the fund life and the nature of the transaction:

- the indemnity monetary limitation can typically vary from 50% of the consideration amount or up to 100% of the consideration; and
- the indemnity time period can vary from the fund life of the private equity seller up to seven years.

Buyers also negotiate for carve-outs from fraud on the part of the seller.

Furthermore, under an exit, management as well as the company may also provide additional business warranties to the buyer and the corresponding indemnity. Customarily, monetary limitation on such warranties can vary from 100% of the consideration to uncapped in relation to breach of fundamental warranties and occurrence of fraud. In certain deals, the parties may also agree on carve-outs in relation to the personal assets of the promoters or founders.

In addition, while a generic disclosure against the data room is not accepted against the warranties, the seller can have a disclosure against the specific warranties. Having said this, disclosure against fundamental warranties is not usually accepted by the buyer.

6.10 Other Protections in Acquisition Documentation

Apart from the protections mentioned in **6.9 Warranty and Indemnity Protection**, warranty and indemnity insurance may also be explored by the buyer or the seller. Warranty and indemnity insurance is, typically, prevalent in cases where there is an indemnity time limitation on the seller on account of its fund life or if the management of the seller is not founder driven. Having said this, the costs for business warranties are typically covered by the target company or split pro-rata among the selling shareholders, and tax insurance is obtained independently by the offshore sellers participating in the sale of securities. In cases where the fund life of the seller is expiring before the completion of the indemnity time limitations, the buyer may even require the general partners of the fund to undertake that the obligations of the seller fund will be satisfied by such general partners post winding-up of such seller fund.

In addition, parties also consider an escrow or retention mechanism wherein a certain percentage of the consideration, to be paid to the seller, is held in escrow to back the indemnity obligations towards the buyer for the breach of the warranties. If the transaction involves a non-resident, then the escrow mechanism is to be in compliance with foreign exchange regulations.

6.11 Commonly Litigated Provisions

In terms of recent commonly litigated provisions, allegations of fraud, siphoning of company's funds by the founders/promoters, non-arm's length related-party transactions, breach of business-related representations or misstatement in the accounts of the company have been a feature. Another key aspect or area of contention are breaches of exit-related clauses by the company or founders.

Customarily, the shareholders' agreement will address the manner for assessment as well as the consequences of these breaches. The consequences for founder breaches will also include a termination of the employment on the account of the fraud as well as a claw-back of securities and resignation from all positions in the company, including automatic resignation of all directors nominated by such founder. However, the authors have seen that such actions initiated are challenged by the founders/promoters and are subject to protracted negotiations or an arbitration process.

7. Takeovers

7.1 Public-to-Private

There are instances of public-to-private transactions, however, they are not as prevalent as transactions involving private companies going public by way of listing.

SEBI (Delisting of Equity Shares) Regulations, 2021, regulates public-to-private transactions in India. The number of such transactions have been relatively low due to the limited effectiveness of purchasing the residual shareholding and the reverse book-built price mechanism prescribed under the above-mentioned regulations.

However, in order to protect the interest of investors and to provide flexibility in the voluntary delisting framework, SEBI has inter alia approved the following measures:

- a fixed-price process as an alternative to a Reverse Book Building process (RBB) for delisting of companies whose shares are frequently traded;
- introduction of an alternate delisting framework for listed Investment Holding Compa-

nies (IHC) through a scheme of arrangement by way of selective capital reduction;
- reduction in the threshold for making a counter-offer under the RBB process from existing 90% to 75%, provided that at least 50% of public shareholdings have been tendered;
- introduction of adjusted book value as an additional parameter for determining floor price for frequently and infrequently traded shares of the companies under the delisting framework, except for the public sector undertakings; and
- modification of the reference date for computing floor price from the existing requirement of approval of the board to the date of initial public announcement for voluntary delisting as in the case of Takeover Regulations.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Under the terms of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (the "Takeover Regulations"):

- any acquirer (together with persons acting in concert (PAC)) holding shares equivalent to or more than 5% in the target company is required to disclose its shareholding; and
- any change in the shareholding of the acquirer of 2% or more is also required to be disclosed.

Further, an acquirer, together with PAC, holding shares or voting rights equivalent to or more than 25% of such listed company shareholding is required to make annual disclosures under the Takeover Regulations.

In addition to this, SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, mandates a quarterly shareholding pattern disclosed by listed entities in India. The shareholding pattern is required to be disclosed across three broad categories:

- promoter and promoter group;
- the public; and
- non-promoter-non-public.

Furthermore, pursuant to the amendment in 2022 under the Listing and Disclosure Regulations, listed companies are now required to provide shareholding details on more categories of shareholders (eg, sovereign wealth funds, foreign portfolio investors, FDI, foreign companies, foreign nationals and non-resident Indians) which are now required to be separately disclosed categories.

7.3 Mandatory Offer Thresholds

The takeover regulations require a mandatory open offer under the following circumstances.

- An acquirer acquiring shares, together with its existing shareholding and along with the shareholding of the PACs, entitles its shareholding to be 25% or more.
- An acquirer holding at least 25% or more shares (together with their PACs) intends to acquire 5% or more shares in the target company.
- Any direct or indirect acquisition of "control" of the target company. Furthermore, the definition of "control" includes the right to appoint the majority of the directors or to control the management or policy decisions of the target company.

Along with the above-mentioned thresholds, if the acquirer already holds a stake that is 25% or more but less than 75% of the target company, in the event it acquires 5% or more of the shares/voting rights in the target company within a financial year then an open offer has to be made.

That being said, the above thresholds are subject to exemptions outlined in the Takeover Regulations. For instance, exemptions may apply in cases of acquisitions following a scheme of arrangement approved by the NCLT or during insolvency resolution proceedings.

7.4 Consideration

In investment transactions, cash is typically the predominant form of consideration. However, in M&A transactions, consideration often involves a combination of shares and cash.

Additionally, all non-resident individuals must adhere to RBI pricing guidelines regarding "fair market value". This ensures that no shares are sold or transferred to non-residents at a price below the fair market value of those shares.

7.5 Conditions in Takeovers

In addition to the mandatory open offer requirements as set out in **7.3 Mandatory Offer Thresholds**, the takeover regulations also prescribe conditions for an acquirer for voluntary open offer, offer size, mode of payment under the offer and withdrawal of offer.

The financing documents by and between the acquirer and the target are entered and executed prior to the opening of the tender offer so that, in addition to the regulatory requirements under the securities law, the rights and obligations of the acquirer as well as the target are documented contractually.

7.6 Acquiring Less Than 100%

The Takeover Regulations require that at least 25% of the share capital of a public listed company should be held by the public at all points in time.

In the event that the public shareholding falls below 25% during an open offer then the acquirer is required to dilute its shareholding to an extent such that the public's shareholding in the listed entity is at least 25%. Alternatively, the acquirer can delist as well at the time of making the open offer in such a situation.

Subject to the above, the Indian Companies Act, 2013, also includes provisions for "squeeze outs". However, minority shareholders can object to such squeeze-out mechanisms on the grounds that it is not is fair and reasonable to the minority shareholders and can block expeditious methods of minority buy out.

7.7 Irrevocable Commitments

Typically, negotiations usually precede the trigger of an open offer by the acquirer to buy the shares in the listed company. The acquirer as well as the promoters and management negotiate the transaction and enter into definitive documents to crystalise the rights and obligations which would flow upon the trigger of the open offer.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentivisation of management-level personnel is a common practice in private equity transactions in India. Companies often utilise mechanisms like employee stock options (including phantom stock options), performance-based payments, bonuses, and stock appreciation rights to ensure alignment with the investor's objectives and milestones. Furthermore, management teams may be issued shares as non-cash consideration to incentivise achievement of performance targets or facilitate exits for institutional investors or listings of securities.

Companies typically allocate an option pool ranging from 7% to 10% of the share capital for employee stock options (ESOPs). The size and structure of this ESOP pool depend on factors such as the company's type, industry, and specific commercial policies implemented by the company and its investors to incentivise employees.

The Companies (Share Capital and Debentures) Rules 2014, exclude an employee who is a founder or a director (who either by themselves or through a relative, or body corporate holds more than 10% of the outstanding equity shares of the company) for issuance of shares from the ESOP pool. This rule is not applicable to a start-up company for a period of ten years from the date of its incorporation or registration.

8.2 Management Participation

In private equity transactions the management shareholders' participation is typically conducted through the following methods:

- management stock options;
- a contractual commitment of sharing the equity upside with the investor over a particular threshold; or
- issuance of warrants.

These options provide both investors and the management team with increased flexibility to structure transactions according to their respective needs and objectives. Having said this, the aforementioned options are in addition to the existing ownership of the management/founder at the time of setting up or incorporation of the company.

8.3 Vesting/Leaver Provisions

In early-stage companies, shares held by founders typically undergo a vesting period of four years. During this period, the shares vest equally on a monthly or quarterly basis, along with a one-year cliff period. Similar to other jurisdictions, this structure ensures alignment of founders' incentives with the long-term success and growth of the company.

In the event of termination or resignation of a founder's employment with the company on or before the vesting of all shares, the unvested shares are typically repurchased by the company (or its nominee) or transferred to the ESOP pool/trust of the company at face value. This is subject to certain exceptions built in for "good leaver" scenarios.

In case of termination of employment on account of "cause" or "bad leaver" events, the vested shares are also bought out or transferred at a discounted value.

8.4 Restrictions on Manager Shareholders

Private equity investors often require investee companies to impose restrictive covenants on founders and key employees. These covenants typically include limitations on transferring shares, investing in other companies, maintaining exclusivity, adhering to non-compete agreements, refraining from soliciting employees or customers, and maintaining confidentiality.

In addition, investors may seek to amend the terms of employment agreements for founders and key employees. This ensures that any employee or founder exiting the company is restricted from joining or establishing competing businesses, soliciting employees, and disclosing confidential company information to unauthorised third parties.

Under Indian law, non-compete obligations that are directly linked to the shareholding of a founder and are aimed at safeguarding or transferring goodwill are generally enforceable. However, non-compete obligations that extend beyond the term of a contract are typically considered invalid (except if there is transfer of "goodwill"). Non-solicit covenants are generally enforceable under Indian law.

8.5 Minority Protection for Manager Shareholders

Management shareholders usually receive governance rights, such as a board seat, along with their equity ownership in the company. Depending on their shareholding and board structure, management or founders for a certain period of time may also have a veto over critical operational or strategic decisions. However, management shareholders generally do not have economic protection in the form of anti-dilution protection or liquidation preference rights (unless in some cases where the management shareholders acquire the same class of securities as the investors, without any discount).

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

Investors negotiate for a range of control mechanisms over their portfolio companies to actively participate in decision-making and monitor financial performance. These mechanisms vary based on several factors such as the type of shares held (equity or preference), the corporation's by-laws and specific governance, and applicable laws and regulations in the jurisdiction where such corporation is incorporated. However, customary rights extended to such investors by the Indian portfolio companies include board appointment, observer seats, affirmative voting rights, information/inspection rights, dividend rights, pre-emptive rights, liquidation rights, and involvement in key managerial personnel appointments, empowering private equity fund shareholders to safeguard their investments and contribute to the long-term success of the portfolio companies. Recent trends indicate an increase in shareholders' activism whereby the institutional investors/shareholders, through consistent interaction with the board, active participation in general meetings and public announcements on transacted matters are strengthening corporate governance policies to bring transparency to the affairs of the company.

In addition to above, the affirmative rights of the shareholders ensure control over management or corporate actions proposed to be undertaken by the company which include matters such as related-party transactions, change in business, alteration of charter documents, corporate restructuring, appointment and removal of key managerial personnel, liquidation, or dissolution of the company, exit-related provisions, litigation, annual budgets and business plans and strategic initiatives.

9.2 Shareholder Liability

In India, the company is seen as a distinct legal entity from the shareholders, and no liability for acts or omissions of the company can be placed on its shareholders. Therefore, the corporate shareholders are typically not liable for the debts or obligations of the company, including legal liability for torts or contractual actions. Separately, there are no statutory duties of shareholders with respect to the corporate entities, except in relation to certain disclosures as per the applicable laws.

However, a court may disregard the corporate protection granted to such shareholders and hold them personally liable in certain exceptional situations wherein piercing of corporate veil establishes the knowledge or intention of such shareholder in the alleged wrongdoing, fraud, money laundering or tax evasion.

10. Exits

10.1 Types of Exit

The exit strategies typically negotiated by private equity firms include private sales to other private investors or corporations and initial public offerings (IPOs). However, other forms of exit include the following.

- Strategic sale/third party sale – The sale of a significant or controlling stake in the company to any third party (not being a competitor of the company) taking control over the operations of the company. The option of a strategic sale is also dependent on the size of the company as well as the exit strategy. More often, early-stage investors are provided liquidity through sale of securities to other financial investors (often linked with a primary fund raise of the company).
- Buyback – In the event that the company is unable to provide an exit to the investors within the exit timeline, then, as an alternative recourse, an option of a company buyback of securities is included in the documents. This is not a preferred exit route, as a buyback is subject to certain restrictions as set out in the (Indian) Companies Act, 2013. Furthermore, the inclusion of this clause in the documents also may result in the auditors of the company recording the same as a contingent liability in the books of accounts.
- Drag-along – This right allows the majority investors/shareholders to require and obligate the other existing shareholders to sell their shares to a third party purchaser at the same price and conditions at which the right-holder proposes to transfer its shares. While the document binds the founders to facilitate the exit in this manner, practically, the exercise of a drag-along right requires transaction assistance from the founders. The pricing and valuation of a drag sale is not different from other modes of sale and is subject to applicable law (for instance, in the case of a non-resident exiting investor, it will be governed by Foreign Exchange Management (Non-Debt Instruments) (Amendment) Rules, 2019).

A dual-track process provides an opportunity for private equity investors to explore the public market while seeking a strategic purchaser or another financial investor. However, it is an expensive procedure for the company and it is difficult for the management to allocate resources to fully commit to evaluating both options in parallel.

10.2 Drag and Tag Rights

Drag as well as tag rights are a common feature in equity transactions. These are designed to protect the interests of both the minority and majority shareholders in the event of a sale.

Typically, a drag is initiated post the exit period or in an event of default. Any liquidation event, such as a merger, acquisition, public listing or sale of assets resulting in a change of control of the company could also trigger such provision. This right is triggered by major financial investors aggregating to at least 51–75% (as applicable) of their inter-se shareholding, and exercised by written notice to the company to require the minority shareholder to transfer any of the shares

as specified in the drag notice in conjunction with an offer received from a third party on the same terms and at the same price. Furthermore, the participation of the founders in such a drag sale can be made necessary, including providing customary representations, warranties and indemnities as required by the third-party buyer. Lastly, if the drag sale does is not comprised of shares held by investors (other than the dragging investors), then the minority investors negotiate a tag-along right to enable them to participate in such transaction.

Tag-related transactions are linked to a sale of securities of the founder. The tag-along is customarily on a pro rata basis with the founder(s). However, a full tag is provided to the investors if such a transfer results in a change in control or the founder's shareholding falling below a negotiated threshold.

Lastly, the parties may also negotiate to include the concept of a housekeeping tag, whereby transfer of shares by one or more shareholders to the third-party buyer results in a change of control scenario. In such a scenario, each shareholder (other than the selling shareholders) shall have the right to require such a third-party buyer to purchase up to all their shares held in the company on the same terms and price offered to the selling shareholders as part of such sale.

10.3 IPO

Lock-in restrictions are governed by the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018. As per these regulations, subject to certain exceptions and categories of investors, the entire pre-issue capital held by persons (other than the promoters) is locked-in for six months from the date of allotment in the initial public offer. Founders' minimum statutory contribution is locked in for 18 months and the amounts in excess of that are locked in for six months.

Under applicable SEBI Regulations, the minimum promoter contribution (MPC) required to be contributed by the promoter in an initial public offering is at least 20% of the post-offer paid-up share capital. However, SEBI has recently relaxed MPC requirements and has permitted non-individual investors holding 5% or more of the post-offer equity share capital of a company, to contribute towards the MPC, without being identified as promoters. This will provide a fillip to entities where significant shareholding is held by institutional PE and VC investors and not the original promoters to undertake exits via the IPO route.

IRELAND

Law and Practice

Contributed by:
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Matheson LLP has the leading private equity practice in the Irish market, with unrivalled expertise advising on the sponsor's entire capital life cycle – from fund formation, fundraising and raising leveraged finance through to investment, asset management, and exit. Matheson's dedicated private equity team adopts a cross-sectoral approach, working closely with specialists in asset management, tax, antitrust, IT, IP, and banking and finance groups to deliver on mandates for a wide range of private equity clients. From six offices in Cork, London, New York, Palo Alto and San Francisco, the team acts for clients across the private equity spectrum (including sponsors, target companies, and founder and management teams) and services clients in all geographies who are active in the Irish market. With a growing team of more than 560 legal, tax and digital services professionals, Matheson has significant bench strength, including sector-specialist lawyers across all areas who have a detailed understanding of the private equity industry.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

In line with global markets, Ireland has seen a cautious start to 2024, which is reflective of broader macroeconomic volatility and geopolitical uncertainty. During the first half of 2024, there has been a 20% decrease in deal volume against the same period in 2023. However, thanks to a number of deals transacted at the upper end of the valuation spectrum (ie, more than EUR500 million), Ireland's deal value figures have remained remarkably robust – with an increase of over 200% against the same period in 2023.

There has been a general trend towards more bilateral deals and fewer auction processes when compared with previous years, reflecting a broader shift to more buyer-friendly market conditions and an increase in the number of strategic acquirers in the market.

In terms of due diligence, there has been a discernible trend in the past 12 months towards expanded financial, legal and technical diligence, whereby the due diligence process in private equity transactions has become more involved and targeted. This appears to be driven – in part – by the requirements of lenders as well as warranties and indemnity insurance ("W&I insurance") underwriters, which has led to an increase in both transaction complexity and timeline.

Due diligence tends to consist of a red-flag review of matters above a specific monetary materiality threshold. This trend towards red-flag, exceptions-only diligence reporting is aligned with the increase in private equity buyers in the market. In particular circumstances, there are sometimes selective "deep dive" diligence exercises carried out on specific aspects depending on the nature of the target business. Contract reviews are generally limited to the target's top ten customer contracts or to those contracts that account for a material proportion of the target's revenue.

There has been a material increase in minority investments undertaken by private equity investors in recent years. This trend is expected to continue as dedicated minority funds look to take advantage of Ireland's favourable fiscal and economic policies. However, from a tax structuring perspective, the availability of Ireland's "substantial shareholders" exemption should be considered, as this relief from capital gains tax only applies where a minimum 5% shareholding has been held for the duration of a specified holding period.

Ireland has always attracted significant levels of inbound investment activity. This trend has continued in 2024, with more than half of all deals involving international acquirers, including three-quarters of the top 20 deals (by value).

1.2 Market Activity and Impact of Macro-Economic Factors

The Irish M&A market has proved resilient during the past 12 months when faced with geopolitical concerns and the prevailing economic headwinds of inflation, supply chain issues and rising energy costs. However, the easing of inflationary headwinds – coupled with increased certainty in relation to interest rates – is having and will continue to have a positive impact on deals requiring acquisition finance.

Although business carve-outs have gained prevalence, share purchases of entire businesses remain the most common buyout method. Asset

purchases continue to be more appropriate only when specific assets or a specific part of the target's business is sought after.

Despite the high interest rate environment, private equity continues to play an outsized role in the Irish M&A market. Although private equity deal volumes were down approximately 19% in the first half of 2024, as against the same period in 2023, almost one in five deals was undertaken by a financial sponsor or a private equity-backed company. Notably, half of Ireland's largest 20 deals in the first half of 2024 involved a private equity acquirer.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

EU FDI Regulation

Previously, there were no specific restrictions on foreign buyers acquiring Irish private companies. However, this has changed following the coming into force of Regulation (EU) 2019/452 of the European Council and of the Parliament establishing a framework for the screening of foreign direct investments (FDI) into the EU (the "EU FDI Regulation") on 11 October 2020.

The EU FDI Regulation applies to a broad range of foreign investments by non-EU countries into EU member states that are likely to affect "security or public order". An investment may be deemed likely to affect security or public order where it could potentially affect certain strategic interests, such as:

- critical infrastructure;
- critical technologies;
- supplies of critical inputs;
- access to sensitive information, including personal data, or the ability to control such information; and
- the freedom and pluralism of the media.

On 31 October 2023, Ireland enacted the Screening of Third Country Transactions Act 2023 (expected to be commenced in Q3 2024), which implemented the EU FDI Regulation. The key points are that this new regime is suspensory (with criminal sanctions), involves very low thresholds, covers a wide variety of sectors, and needs to be considered in parallel with merger control rules. It remains to be seen how it will be implemented in practice; however, the Department of Enterprise, Trade and Employment has published draft guidance documents.

Under the new legislation, a new mandatory notification to undertake a "screening procedure" by the Minister for Enterprise, Trade and Employment will be required for certain transactions to which third-country or foreign-controlled undertakings (this includes both companies and individuals outside the EU, the European Economic Area (EEA) and Switzerland) are parties if the following conditions are met:

- a third-country undertaking or a connected person is a party to the transaction;
- the value of the transaction is at least EUR2 million;
- the transaction relates to or impacts critical infrastructure, critical technologies or dual-use items, critical inputs including natural resources, access to sensitive data, and/or the freedom and plurality of the media; and
- the transaction relates to an asset or undertaking in the state.

A "transaction" includes any transaction or proposed transaction where a change of control of

an asset or the acquisition of all or part of an undertaking in the state is affected. The concept of "control" is the same as in the EU and Irish merger control regimes and relates to "direct or indirect influence" over the activities of the undertaking (eg, voting rights or securities, ownership of assets of the undertaking, or rights and contracts providing influence over the decisions of the undertaking).

Transactions for the acquisition of shares or voting rights only have to be notified where the above-mentioned criteria are fulfilled and where the percentage of shares or voting rights held changes from:

- less than 25% to more than 25%; and
- less than 50% to more than 50%.

It remains to be seen how this will be implemented in practice. However, broadly speaking, Ireland is expected to remain very "FDI-friendly".

Investment Limited Partnerships

The use of Investment Limited Partnerships (ILPs) by private asset managers has increased in recent years, following an overhaul of the partnership legislative regime in Ireland in 2021. The ILP now offers the key features and functionality managers and investors have come to expect from similar vehicles in jurisdictions such as the Cayman Islands and Luxembourg, but in the Irish regulatory, tax and service provider environment.

The ILP incorporates standard private equity and real asset fund features such as closed-ended structures, excuse provisions and exclude provisions, capital accounting, commitments, capital contributions and drawdowns, defaulting investor provisions, distribution waterfalls and carried interest, and advisory committees. In addition, the ILP is tax-transparent for Irish tax purposes and one of the ILP's key features – compared to similar vehicles in other jurisdictions – is its ability to be structured as an umbrella fund with separate sub-funds (including segregated liability between those sub-funds).

More than 50 ILPs have now been established in Ireland and the feedback from managers and investors regarding their experiences of the new structure has been very positive, in terms of the structure itself, the level of fundraising that was achieved following the introduction of the new ILP-based products, and the pragmatic approach experienced in establishing an ILP in Ireland as compared to other jurisdictions. The positive experiences of those who have already established ILPs are expected to continue to drive further activity by other financial sponsors in these areas.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

See the responses at **2.1 Impact of Legal Developments on Funds and Transactions** regarding FDI and **6.4 Conditionality in Acquisition Documentation** regarding merger control.

There have been no major Irish law developments on sanctions or anti-bribery in the past 12 months. Ireland participates in the EU decision-making process when taking sanctions decisions at the EU level but does not adopt sanctions autonomously. The EU regularly adopts new sanctions all the time (particularly against Russia and in relation to its invasion of Ukraine) and Ireland follows those decisions. Ireland's anti-bribery laws were last updated in 2018 (Criminal Justice Act 2018).

In terms of ESG regulations, Ireland has recently (July 2024) transposed the EU's Corporate Sustainability Reporting Directive (CSRD) into Irish law. The CSRD introduced the EU's new mandatory sustainability reporting regime, which many Irish companies will be required to comply with in respect of their next financial year. Portfolio companies are preparing for reporting under the new regime and their financial sponsors are considering how to incorporate the wealth of new non-financial reporting that will be produced into their existing metrics – as well as the challenges that will arise for new acquisitions, where the target does not report under CSRD or has different reporting structures.

Private equity firms with larger portfolio companies are also considering the impact of the Corporate Sustainability Due Diligence Directive, which came into law in the EU in the middle of 2024 and will begin to apply to companies in 2027. Under this new regime, in-scope companies (and, indirectly, their customers and suppliers) will be required to incorporate sustainability due diligence into their operations and strategy.

4. Due Diligence

4.1 General Information

Due diligence is usually carried out by the buyer's legal advisers. Typically, the buyer's lawyers share a due diligence questionnaire (DDQ) with the seller's lawyers, which will contain a list of questions for them. These are usually categorised under a number of headings, including:

- accounts;
- data protection;
- employment and pensions;
- financial arrangements;
- intellectual property;
- key contracts;
- litigation and disputes;
- real estate;
- regulatory;
- ESG;
- share capital and corporate structure; and
- tax.

The buyer's lawyers will also request documents from the seller's lawyers. The seller will then upload these documents to a virtual data room (VDR), to which the buyer, seller and their respective advisors have access.

The seller's lawyers will respond to the questions raised in the DDQ. This allows the buyer's lawyers to raise follow-up questions and/or request that further documents be uploaded to the VDR.

The buyer's lawyers draft a legal due diligence report addressed to the buyer, outlining the issues identified during the due diligence exercise and advising as to how they can be dealt with. The buyer's lawyers typically have detailed instructions regarding the scope of the due diligence (and the materiality threshold to be applied); the report will only address issues within this scope.

In recent years, areas such as data protection – and, in particular, General Data Protection Regulation (GDPR) compliance – have been given very high priority in the due diligence process, owing to the potential for punitive penalties arising from breaches of the GDPR. In addition, there has been a large focus on pensions arrangements and ESG issues as part of legal due diligence, due to changes to legislation affecting private pensions schemes and various ESG regulation (discussed in **3.1 Primary Regulators and Regulatory Issues**).

4.2 Vendor Due Diligence

While there has a been an observable trend towards more bilateral deals, private equity sellers continue to favour sales by auction. A vendor due diligence (VDD) report is typically part of an auction process and involves the vendor providing a report or legal fact book that describes the business and any potential impediments to an acquisition. These are typically provided on the basis of a specified scope of review and include analysis of limited aspects (eg, change of control provisions in commercial contracts). The vendor's advisers will typically provide reliance on the VDD report.

5. Structure of Transactions

5.1 Structure of the Acquisition

The vast majority of transactions are structured as share sales. However, there has been an increase in the number of asset sales in the form of business carve-outs where certain large corporates seek to focus on their core business lines and dispose of non-core assets. Asset purchases and business transfers can be more appropriate where a specific part of the target's business is being acquired and therefore needs to be carved out from the larger business, which may be appropriate in certain sectors.

While there has been a recent trend towards bilateral transactions, auction sales remain common, particularly where private equity investors seek to exit their investment. No specific regulatory restrictions apply and the structuring of the terms will largely be business- and/or timing-specific.

It is essential that a robust non-disclosure agreement is entered into before commercially sensitive information is shared with potential bidders. Generally, a non-disclosure agreement is entered into with potential bidders before the information memorandum is shared.

Even though in the majority of cases the highest bidder is successful in an auction process, there is no requirement for the seller to accept the highest bid. Where mark-ups of the primary transaction documents are required as part of the bid process, the form of the mark-up can influence the determination of the successful bidder. Although privately negotiated transactions and auction sales will typically be conducted on similar terms, in an auction sale there is typically less scope for negotiation by the bidders, and sellers will look to maintain competitive tension for the duration of the process.

5.2 Structure of the Buyer

Private equity transactions are typically structured in Ireland using either a double or triple "stack". This usually consists of:

- a top holding company ("HoldCo") through which the private equity fund will holds its equity;
- an intermediate holding company (which, depending on the overall funding structure for the deal, will typically be used to hold the private equity fund's shareholder debt); and
- the purchaser vehicle ("BidCo"), which will be the vehicle used to acquire the shares in the target company.

The primary role of the BidCo is to acquire and hold the target's shares; however, it may also act as a borrower under debt facilities. For tax purposes, it is common to have multiple holding companies inserted between the HoldCo and the BidCo.

For inbound investments, the BidCo is typically a private limited company resident for tax purposes in Ireland. The jurisdiction of incorporation of the BidCo can vary and may be offshore or onshore.

The structure of a private equity investor will typically differ where the investor is acquiring a minority position in the target company. Such investments will typically be structured directly through an existing entity rather than through a BidCo. In outright buyouts, it is very uncommon in Ireland for the private equity investor itself (or one of its funds) to act as the BidCo, for the above-mentioned reasons.

5.3 Funding Structure of Private Equity Transactions

In an Irish context, an equity commitment letter is typically provided ahead of funds being drawn down. In the context of third-party debt financing, it is less common for the lender (whether that be a traditional bank or a private credit lender) to provide a letter of commitment (or equivalent). This has not changed noticeably in the past 12 months – although, where such third-party debt finance is being utilised, there has been a more recent trend towards lenders undertaking a greater level of due diligence and requiring tighter financial covenants.

5.4 Multiple Investors

M&A deal activity involving a consortium of private equity sponsors is not common in Ireland. Private equity transactions are commonly financed through a mixture of equity provided by a private equity sponsor in combination with third-party debt finance, which is arranged by the private equity sponsor. It is, however, not unusual to see a consortium of investors (such as pension funds) co-invest via one bespoke private equity fund.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Forms of Consideration

The most prevalent form of consideration used in Irish transactions remains cash consideration. However, other forms of consideration are permissible.

Share consideration has emerged as a prevalent form of consideration, coinciding with the increase in private equity activity in Ireland. Typically, share consideration will be used in the context of management shareholders who sell their shares in the target in consideration for the issuance of shares to them in the buyer's group – integrating the management shareholders into the private equity structure.

Factors in Choice of Consideration

Depending on the transaction structure, consideration can often be structured to incorporate hold-backs or earn-outs in order to provide a private equity buyer with protection against future warranty claims or deteriorating future performance. Earn-outs, in particular, have been commonly used in recent years to bridge valuation gaps. While still a prevalent feature of private equity transactions, deferred consideration has become less attractive following the increase in popularity of W&I insurance, which has de-risked recovery for future claims. Tax structuring can also be an important factor in determining the form the consideration will take, particularly in the context of a management rollover.

Deferred Consideration

The use of deferred consideration, earn-outs, and escrow arrangements is increasing as the market rebalances following the impacts of

COVID-19 and the related liquidity injection into the market.

Locked-Box Consideration Structures

Locked-box structures involve the agreement of a final purchase price using the company's recent audited financial statements – or, where there has been a material gap, a later set of locked-box accounts – and there are no provisions for post-completion adjustment of the purchase price. Locked-box structures are generally preferred by private equity sellers, as they offer the distinct advantages of:

- certainty in the purchase price;
- greater control over financial information;
- reduced contractual liability; and
- expedited distribution of capital.

Locked-box structures have increased in prevalence as the private equity M&A landscape has matured in Ireland.

Completion Accounts

While there has been a material increase in the number of transactions utilising the locked-box consideration structure, completion accounts remain the most commonly used and preferred consideration mechanism among trade sellers. The consideration structure remains the most significant difference between trade sellers and private equity sellers, with the latter typically preferring a locked-box mechanism. It is also dependent on the sector and the deal structure, as completion accounts are often particularly preferred in circumstances where there may have been a pre-sale carve-out.

6.2 Locked-Box Consideration Structures

Where a fixed-price locked-box consideration structure is used and a business is expected to generate excess cash profits during the period between the locked-box date and completion, some form of equity ticker or interest charged on the equity price will often be included as a means of compensating the seller for the time lag between the locked-box date and completion. However, this will largely depend on the bargaining power of the parties and the nature of the underlying business. By way of example, in certain pre-revenue businesses in the technology or energy and infrastructure sectors, it would be unusual to see an equity ticker where the target is loss-making and pre-revenue – given the target is unlikely to hold any excess cash profits made between the locked-box date and completion.

6.3 Dispute Resolution for Consideration Structures

It is typical, irrespective of the consideration mechanism, to have a dedicated expert or other dispute resolution mechanism in place for consideration structures in private equity transactions.

The most common provision is for disputes to be referred to a dedicated expert, with the appropriate expertise and level of experience, for determination. This is often by reference to the Big Four accounting firms.

More generally, there has also been an increase in the inclusion of arbitration clauses. These usually involve the parties agreeing that any disputes arising between them be referred to arbitration and that neither party can pursue litigation until the arbitration process has been exhausted.

6.4 Conditionality in Acquisition Documentation

Regulatory Approval

Private equity transactions in Ireland are subject to regulatory approval by the Competition and Consumer Protection Commission (CCPC). The substantive test for clearance applied by the CCPC is whether the merger would substantially lessen competition in the relevant markets for goods or services in Ireland.

For media mergers, there is a further step whereby the Minister for Communications, Climate Action and Environment then applies a media plurality test to determine whether the merger would be contrary to the public interest in protecting the plurality of the media in Ireland.

See **2.1 Impact of Legal Developments on Funds and Transactions** for a discussion of Ireland's implementation of the EU FDI Regulation, which provides for a new mandatory notification to and "screening procedure" by the Minister for Enterprise, Trade and Employment for certain transactions.

Conditions Precedent

In general, parties seek to avoid conditionality in order to make the terms of a deal more certain and there has been increased focus from sellers on conditionality in the past 18 months. Where conditions precedent are provided for in share sale agreements, they are typically limited to the following:

- obtaining change-of-control consents from key customers and/or suppliers, so as to ensure that key strategic contracts are preserved for the buyer;
- a requirement that specified permits, licences or consents are obtained to enable the buyer to complete the purchase and/or carry on the business;
- where the company operates in a regulated sector, obtaining all necessary regulatory consents and waivers;
- shareholder consent, which may be required in certain circumstances – in particular, where one of the parties is a listed company; and
- other transaction-specific conditions.

6.5 "Hell or High Water" Undertakings

In Ireland, competition clearances are (where applicable) a condition precedent to completion, with completion pending approval from a regulator such as the CCPC. (This is also expected to be the approach taken once the FDI regime comes into force in September 2024.) The risks of merger control clearance are often passed on to the purchaser by the use of a "hell or high water" (HOHW) clause, which may include an obligation on the purchaser to:

- make divestments
- agree to behavioural commitments; or
- litigate in the event the transaction is blocked by the CCPC.

In the authors' experience, private equity-backed buyers generally do not accept HOHW undertakings in Irish deals that involve a regulatory condition. However, it should be noted that buyers may be more open to accepting such undertakings under certain conditions – for example, in the case of a "no-overlaps" concentration (ie, where there is generally no prospect of a significant competition issue). At present, it is more common for HOHW undertakings to be utilised in relation to merger-control/antitrust conditions, rather than for foreign investment/subsidisation conditions under the FDI or Foreign Subsidies Regulation (FSR) regimes. This position may evolve in relation to the new FSR

and FDI regimes over time – particularly in terms of the FDI regime, when the Screening of Third Country Transactions Act commences in September 2024.

6.6 Break Fees

The inclusion of break fees or reverse break fees in private equity transactions remains rare. This is down to the reticence of private equity buyers to agree to pay costs in the event that a transaction does not reach completion.

Break fees are common, however, in public company takeovers and are permissible under the applicable Irish takeover rules (see **7.1 Public-to-Private**), provided that the Irish Takeover Panel has expressly consented to them. Such consent is ordinarily only given where the Irish Takeover Panel is satisfied that:

- the break fee relates to specific quantifiable third-party costs;
- it is capped at 1% of the value of the offer at the time the firm announces its intention to make the offer payable; and
- written confirmation has been received from the board and financial adviser of the target, stating that they believe that the break fee is in the best interests of their shareholders.

6.7 Termination Rights in Acquisition Documentation

As mentioned in **6.4 Conditionality in Acquisition Documentation**, outside of regulatory requirements, parties tend to avoid conditionality. Where a deal is subject to regulatory approval and it is not received, the other party may terminate.

Parties will generally put in place a longstop date. These periods have been extended in recent times, owing to the increase in the number of third parties involved in deals, as well as the increased complexity of deals.

When agreeing upon a longstop date, it is crucial that buyers and sellers consider whether closing conditions are feasible within the given timeframe or may take longer than otherwise anticipated. It is also useful to consider the circumstances in which a longstop date may be extended or adapted. The longstop date will vary depending upon the nature of the transaction but is typically up to 12 months.

6.8 Allocation of Risk

The allocation of risk between a buyer and seller will depend on the nature of the transaction and the underlying business or asset(s). However, current market conditions favour sellers, so this can lead to the buy-side bearing more risk.

W&I insurance has become increasingly prevalent in Irish deals during the past few years. Such policies serve to reduce the seller's liability and, in the case of some assets, liability can be limited to as little as one euro.

In line with market practice, private equity-backed sellers will typically bear very little risk outside of title and capacity warranties. In the authors' experience, both trade sellers and trade buyers in the Irish market will often bear more risk on transactions.

6.9 Warranty and Indemnity Protection

Typically, a buyer will endeavour to include far-reaching and broadly drafted warranties, whereas a seller will seek to limit the scope of the warranty language so as to reduce the likelihood – and financial consequences – of a warranty claim. Due diligence reports are deemed to be disclosed against the warranties given for the purposes of the W&I policy, effectively put-

ting the purchaser on notice of all the matters contained therein and excluding liability for such matters. In recent years, it has become increasingly common for the VDR to be disclosed.

Private equity sellers will typically only give fundamental warranties in respect of title and capacity. Although the target's management team may – to varying degrees – provide business and operational warranty cover, the cap on liability for such management warranties will typically be significantly lower than the overall purchase price. This has resulted in the widespread use of W&I insurance in private equity M&A deals.

Financial caps on seller liability for breach of warranty claims of between 25% and 50% of the overall purchase price is common on mid-market and higher-value transactions, whereas historically market practice in Ireland would have been for 100% of the overall purchase price to be "on risk" for breaches of warranty. Known issues are typically excluded, except in the case of fraud.

Customary time limits on fundamental warranties and tax warranties can be up to five or six years, whereas for business warranties the time period is typically 12 to 24 months. Given that private equity sellers typically insist on a W&I policy, there is no difference in the periods provided, save that W&I providers will often extend the time periods to six or seven years and three years respectively.

6.10 Other Protections in Acquisition Documentation

W&I insurance has, over the years, become a popular means used by parties in private equity transactions to bridge the gap between the desired level of warranty coverage from a buyer perspective and the level of exposure a seller is willing to assume in respect of potential warranty claims on the sale of a company or business.

Even though the level of cover will vary, the policy can be used to reduce the seller's liability to as low as one euro for certain assets and, in particular, property assets – although the one euro cap is being applied more and more in other industries. However, the seller typically retains risk for the title and capacity warranties, and – if found to have acted fraudulently or engaged in wilful misconduct – will retain full liability.

W&I insurance is now common in respect of fundamental and/or business warranties and also for tax warranties. In Ireland, a separate tax deed is typically also used to allocate tax risk between a buyer and seller on a euro-for-euro indemnity basis. More recently, W&I providers have been willing to cover tax deeds in full under the W&I policy, subject to certain customary carve-outs.

Owing to the prevalence of W&I insurance, and the insurer's appetite to provide specified cover for certain indemnities, it is no longer common to have an escrow or retention in place to back the obligations of a private equity seller. We rarely see escrow or retention arrangements save for bespoke deal-specific risks in deals that carry a high value or probability of risk.

6.11 Commonly Litigated Provisions

Litigation is relatively uncommon in private equity transactions in Ireland. This is partially attributable to the limited warranty liability provided by private equity sellers. Where disputes arise, they typically relate to the consideration mechanism and earn-outs.

7. Takeovers

7.1 Public-to-Private

Public-to-private transactions by private equity-backed bidders are rare in the Irish market – there are seldom more than one or two a year (and often none). The authors have noted an increase in the number of enquiries where clients were exploring opportunities in this space, particularly in light of the pressure on public market valuations.

It is typical for transaction agreements to be entered into in public-to-private acquisitions. Such transaction agreements will usually be governed under Irish law.

A public-to-private transaction is regulated by the provisions of the Irish Takeover Panel Act 1997 (as amended), as well as the Irish Takeover Rules 2022 and the European Communities (Takeover Bids (Directive 2004/25/EC)) Regulations 2006 (together, the "Takeover Rules"). The Takeover Rules regulate the conduct of takeovers of Irish companies listed on certain stock exchanges. The Irish Takeover Panel (the "Takeover Panel") is the regulatory body that is tasked with overseeing the application of the Takeover Rules to specific transactions. The rules impose a rigourous framework on such transactions and mandate engagement by private equity investors with the Takeover Panel.

While the application of the Takeover Rules means that such transactions are generally subject to a more restrictive framework than a typical private company transaction, there are three particular Takeover Rules features of note, as follows.

- A transaction must be independently cash-confirmed before a bidder can announce a firm intention to make an offer. For a private equity investor, this means that – at the time of announcement – its funding will need to be unconditionally available to the bidder (including possibly being placed in escrow).
- Once a firm intention to make an offer is announced, a bidder will generally be bound to proceed with the offer. Furthermore, save for the acceptance condition or any competition/antitrust condition, the bidder will have limited scope to invoke any other condition to lapse or withdraw an offer once the offer is made. This increases the importance of due diligence for the private equity investor.
- Special arrangements with any category of target shareholder, including management incentivisation proposals, will generally require consent to be granted by the Takeover Panel. Such consent may be given subject to independent shareholder approval at a general meeting. This necessitates the early formulation of such arrangements or proposals and engagement with the Takeover Panel.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Until the time of announcement of an intention to make an offer under the Takeover Rules, the Substantial Acquisition Rules (SARs) apply to a person acquiring shares and impose restrictions on the timeline within which a person may increase a shareholding in the target.

The SARs prohibit the acquisition by any person (or person acting in concert with that person) of shares or rights in shares carrying 10% or more of the voting rights in an issuer within a period of seven calendar days if that acquisition would take that person's holding of voting rights to 15% or more but less than 30% of the voting rights in the issuer.

Dealings in the securities of a target company that is in an offer period under the Takeover Rules (and, in certain circumstances, dealings in the securities of a bidder) may trigger a disclosure requirement. The Takeover Rules require that a bidder publicly disclose any acquisition of target securities or derivatives referenced to such securities, including those that are purely cash-settled contracts for difference. Other persons interested in 1% or more of the target's securities are also required to publicly disclose their dealings during an offer period. Complex rules apply to exempt fund managers and principal traders, particularly when they are members of a group that includes the bidder or a financial adviser to the bidder.

In Ireland, certain disclosure obligations may arise under the Transparency Directive regime, which has been transposed into Irish law through the Transparency (Directive 2004/109/EC) Regulations 2007 (as amended) and the Central Bank of (Investment Market Conduct) Rules 2019 (together, the "Transparency Rules"). The Transparency Rules, which may apply depending on which market the target is listed upon, require a stakeholder to notify a listed company once the percentage of voting rights acquired by that stakeholder reaches, exceeds or falls below 3% (and then each 1% thereafter).

The Companies Act 2014, as amended, requires that a notification be made within a prescribed timeframe where there is a change in the percentage of shares held by a person in a public limited company resulting in:

- an increase from below to above 3%;
- a decrease from above to below 3%; or
- where the 3% threshold is exceeded both before and after the transaction, but the percentage level in whole numbers changes (fractions of a percentage being rounded down).

7.3 Mandatory Offer Thresholds

The Takeover Rules contain mandatory offer requirements that apply according to the following thresholds:

- where any person, or any persons acting in concert, acquire control of a relevant company; and
- where any person, or any persons acting in concert, who control a relevant company acquire within any period of 12 months additional securities of such an amount as will increase by more than 0.05% the aggregate percentage of the voting rights in that company conferred by the securities held by them.

If a transaction falls within the above-mentioned criteria, except with consent of the Takeover Panel, an offer made must – in respect of each class of shares – be in cash (inclusive of cash alternatives) at a price per share that shall not be less than the highest value of the consideration per share paid by the offeror of that class during the 12 months immediately prior to the announcement of the offer.

7.4 Consideration

Please see **6.1 Types of Consideration Mechanisms**.

With regard to any minimum price rules applicable to tender offers, a bidder may be required to make a cash or cash alternative offer matching the highest price that it previously paid for target shares in a number of circumstances. If the bidder (or any person acting in concert with it) has, in the 12 months prior to the commencement of the offer period, purchased securities of the target carrying in aggregate 10% or more

in nominal value of any class of share that is the subject of the offer, then any offer for that class of share must be in cash or accompanied by a cash alternative at no less than the highest price paid by the bidder or concert party for that share in the relevant period. The Takeover Panel has the discretion to remove the 10% threshold and apply the rule to any acquisition, irrespective of the percentage acquired.

7.5 Conditions in Takeovers

Unless the Takeover Panel otherwise consents, a bidder is not typically permitted to include any:

- pre-conditions to announcing an offer (other than receipt of irrevocable undertakings);
- conditions to completion of an offer, which depends solely on the subjective judgements of the bidder or the target or is within their control (conditions relating to required targets' shareholder acceptance levels and regulatory conditions are permitted); or
- conditions relating to financing.

In addition, neither bidder nor target are permitted to invoke any condition (other than the acceptance condition and certain required competition law clearances) without the Takeover Panel's consent. Such consent will only be given where the circumstances that give rise to the right to invoke the condition are of material significance to the bidder or the target, as the case may be, in the context of the offer and the Takeover Panel is satisfied in the prevailing circumstances that it would be reasonable for the condition to be invoked.

Practically, while certain "material adverse change"-type conditions are included in offers, Takeover Panel consent to invoke such a condition will be required and such consent will not be readily provided.

In Irish recommended public takeovers, a transaction facilitation agreement usually provides for certain deal protection mechanisms, including match rights, force-the-vote provisions and non-solicitation provisions. Break fees of up to 1% covering transaction costs are permitted with Takeover Panel consent. Reverse termination fees (ie, providing for payment by the bidder to the target) are also permissible under Irish law, without an upper limit.

Where the offer is for cash or includes an element of cash, the formal offer announcement must include confirmation by the offeror's financial adviser that resources are and will be available to satisfy full acceptance of the offer.

In Irish public takeovers, private equity funds will typically issue hard-equity commitment letters, which commit the fund to invest in the bid vehicle in order to pay the offer price. Limited conditionality is permissible in debt facilities.

7.6 Acquiring Less Than 100%

There is a variety of governance structures used, ranging from ordinary equity investments with certain control rights to preferred equity or debt-like structures with limited governance rights but with the ability to participate in equity returns. Although not a major feature of the Irish market in recent years, mezzanine debt and convertibles have also become more common. Typically, a financial sponsor who is taking a minority position will seek certain rights and protections, including tag-along and drag-along rights, the ability to appoint a director, a right to information about the company, rights of first refusal in respect of new equity or debt issuances, and board representation rights. It is important that a well-negotiated shareholders' agreement is put in place to ensure a minority investor obtains adequate protection, but in a way that does not

unduly stifle the development of the relevant business.

A private equity minority investor will usually include specific covenants in a shareholders' agreement (or investment agreement) to ensure it has control over material business decisions made by the portfolio company. The main investment agreement will typically:

- allow the private equity fund to control the composition of the group's board of directors;
- include veto rights over material business decisions; and
- oblige the management team to submit regular financial and event-driven reporting to the private equity fund for the purpose of monitoring its investment.

Alternatively, or in parallel with a shareholders' agreement, a private equity fund will hold the majority of voting rights in the target entity to ensure control over material business decisions.

Debt push-downs provide a tax-efficient acquisition-structuring option for private equity buyers whereby an Irish BidCo can obtain interest tax deductions for interest on debt financing obtained for the purpose of the transaction. In terms of applicable thresholds, the BidCo and the target must be part of the same corporation tax group.

The most common squeeze-out mechanism in the context of Irish public limited companies is a scheme of arrangement, which is a statutory procedure that has the effect of rearranging the capital structure of a company and any existing arrangements with creditors. A scheme of arrangement requires majority approval from each shareholder class (representing not less than 75% of the voting shares in each class), as well as the approval of the High Court of Ireland.

7.7 Irrevocable Commitments

In larger transactions, it is common for irrevocable commitments to be sought from major shareholders to ensure that the terms of the offer are accepted and to bind the shareholders to selling their shares to the buyer. This commitment is usually given before the offer is made, as it offers certainty to the bidder in relation to their chances of being successful.

An irrevocable commitment is binding on shareholders and will generally set out a timeframe for the shareholders to accept the offer. Such commitments are regulated by the Takeover Rules.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Management incentivisation is a hallmark of Irish private equity transactions and is typically a key element of a private equity firm's three-to-five-year business plan.

Management will generally subscribe for ordinary shares in the HoldCo representing between 5% and 15% of the overall share capital. Such equity is commonly referred to as sweet equity. The sweet equity shares will typically have nominal value initially on completion of the buyout transaction and they will typically be non-voting and subject to good leaver and bad leaver vesting provisions. Where there are a large number of managers in the sweet equity pool, a new nominee company or trust vehicle ("NomineeCo") will often be set up by the private equity fund to hold the legal interest in the shares on behalf of management.

8.2 Management Participation

As referenced in **8.1 Equity Incentivisation and Ownership**, where there is a larger pool of management investing in sweet equity, it is common for a management pooling vehicle or NomineeCo to be utilised. The NomineeCo will typically hold the beneficial interest in the non-voting shares on trust for the management team. Private equity funds will typically engage tax advisers to structure a NomineeCo in a tax-advantageous manner for the participants on exit.

See **8.1 Equity Incentivisation and Ownership** for a description of sweet equity terms. In addition, where management are also sellers and are reinvesting a portion of their sale proceeds, they will typically reinvest by way of a share-for-share exchange and receive ordinary shares in the same entity as the financial sponsor holds their equity. Such reinvestment can often be a mix of ordinary equity and preferred equity, which will be on similar terms to shareholder debt from the financial sponsor.

It is notable that, given the increasing number of US financial sponsors that are active in the Irish market, there is increasingly more of a US-style approach to management equity, with more prescribed key performance indicators required to be satisfied in order for the management sweet equity pot to become participating on an exit.

8.3 Vesting/Leaver Provisions

Management equity will typically be subject to both vesting and good-leaver/bad-leaver provisions, whereby – in circumstances where a member of the management team leaves the business prior to an exit – such shares can be repurchased from the relevant manager at a nominal or agreed price. The valuation will depend upon the circumstances in which the manager leaves (ie, whether the manager is a good leaver, a bad leaver or a very bad leaver).

Good-leaver/bad-leaver provisions will determine the amount payable to the departing participant. A “good leaver” will commonly obtain a fair market value for their shareholding on exit, whereas a “bad leaver” typically obtains the nominal value of their shareholding. It is common practice for such vesting provisions to include claw-backs whereby an individual that has been designated as a “good leaver” may be required to reimburse their windfall for subsequent breaches of restrictive covenants or other material provisions.

Historically, leaver provisions were drafted heavily in favour of the private equity fund, including an expansive definition of “bad leaver”. However, as competition for suitable assets increases, it is increasingly common for private equity funds to have a more management-friendly leaver provision whereby a “bad leaver” is defined with reference to specific circumstances, such as:

- breaches of restrictive covenants; or
- defined events of default.

8.4 Restrictions on Manager Shareholders

Management shareholders are generally subject to restrictive covenants in Ireland, including non-compete, non-solicitation and non-disparagement undertakings. Such restrictive covenants can be included in both the equity package and the employment contracts to be entered into as part of completion. However, such provisions should be carefully drafted in light of the delicate balancing act between disruption of competition coupled with the right to earn a livelihood and the protection of a legitimate business interest. The basic position is that restrictive covenants

are, prima facie, unenforceable for being unduly in restraint of trade – unless the party seeking to rely on them can demonstrate that the restrictions in question are no more than what is strictly necessary to protect a legitimate business interest and are not otherwise contrary to the public interest.

In general, in Ireland, a non-compete is unlikely to raise concerns if:

- it is limited to a duration of two years (where goodwill is being transferred);
- it is limited to a duration of three years (where know-how also transfers); and
- it relates strictly to the business being acquired and is limited to the territory in which that business already operates.

8.5 Minority Protection for Manager Shareholders

Management does not typically enjoy veto rights over the day-to-day or strategic decisions of the company, which:

- in the case of the former, will be determined by the board; and
- in the latter case, will be reserved for the investor through reserved matters.

Depending on the structure of the agreement in place between the investor and management, it is often the case that certain limited matters will be reserved specifically for management either through specific reserved matters or by requiring unanimous board approval (where management is represented on the board).

Typically, but not always, management are awarded pre-emption rights to avoid dilution. Ratchet mechanisms are also utilised to vary the amount of equity held by management and can act as an anti-dilution protection where more sweet equity is issued to other managers at a later stage.

It is uncommon in Ireland for management to be awarded a right to control or influence the exit of the investor, unless management is awarded a controlling percentage of strip equity in the ultimate holding company. The only exception to this is where the private equity investor is participating in a joint venture or the nature of the arrangement is such that it is more akin to a joint venture.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

In addition to holding the majority of the voting rights in a target or HoldCo, private equity investors will seek to include specific covenants and management provisions in any shareholders' agreement entered into with management to ensure they have control over the material business decisions made by the target.

The transaction documents will typically provide for the private equity investor to assume control of the composition of the target's board of directors, including veto rights over material business decisions and provisions for the submission of regular financial and event-driven reporting to the sponsor, creating an oversight mechanism for the private equity investor. Notably, there has been an increased focus on ESG and regulatory reporting obligations, including flexibility to update policies and reporting formats to enable financial sponsors to adapt to their evolving reporting obligations.

Financial sponsors will also look to include emergency powers with step-in rights and freezing of certain management rights during certain periods or on the occurrence of certain events. There is often a catch-up right for management if there are debt or equity issuances during such emergency periods.

9.2 Shareholder Liability

An Irish private equity fund will generally be structured as a limited partnership. Its wholly owned subsidiaries utilised as investment vehicles will usually be incorporated as private limited companies.

Thus, provided the portfolio company is a limited liability company, it will enjoy a separate legal personality and Irish courts will not “pierce the corporate veil” to impose personal liability on shareholders for the actions of its portfolio company unless there has been fraudulent activity. Irish legislation also provides for limited circumstances where the corporate veil can be pierced – for example, in the context of environmental or health and safety legislation or where “pooling orders” have been made. The effect of these provisions is that management and, in even more limited circumstances, shareholders can be made liable for the acts or omissions of a portfolio company – although such events are extremely rare in Ireland.

10. Exits

10.1 Types of Exit

In recent years, exits in Ireland are typically achieved via a sale process to other private equity-backed investors or corporates, rather than by IPO. This usually takes the form of a sale or liquidation of the portfolio company. This is so, given the recent lack of IPOs in the Irish market.

Although it remains rare for a private equity investor to continue to be a shareholder in a portfolio company beyond the term of the initial investment, continuation funds are emerging as a viable exit alternative for private equity investors. This is a particularly useful option where investors foresee a better exit down the line and additional liquidity will assist in making this more likely.

10.2 Drag and Tag Rights

Drag and tag rights are staple provisions in most equity arrangements in Ireland. They are usually structured with the aim of making a sale more attractive to potential buyers by providing a mechanism to allow for the entire interest in a company to be sold.

Although drag rights are commonly provided for in shareholders’ agreements, they are rarely utilised in practice. Where they do arise, it will generally be the private equity fund that has the right to exercise them and only very rarely will a fund be subject to being dragged along.

Tag rights are also common in Ireland and allow for minority shareholders to have the opportunity to sell their shares on the same terms as the majority shareholder(s).

The threshold to enforce these rights, whether tag or drag, will usually depend on the equity structure of the company in question.

10.3 IPO

In recent years, Irish companies have generally avoided going to market via IPO, with many existing shareholders instead preferring to exit via M&A. However, a number of Irish companies have chosen to go public in the USA via “deSPAC” transactions, whereby an existing listed “blank cheque” company merges with the

Irish target and the Irish target gains a US listing (SPAC listings have generally not been possible in Ireland and the UK, owing to local listing rules).

In the case of deSPAC transactions, it is common that the large shareholders (including private equity sellers) will be required to enter into lock-up agreements in advance of completion and listing. The terms of lock-up agreements may vary, but most prevent the locked-up parties from selling their shares for a period of 180 days after completion and listing. In more recent transactions, there has been a move towards stepped lock-ups, which permit the sale of shares in tranches at predetermined intervals.

Relationship agreements that include board appointment and information rights are, in principle, permissible under Irish law (subject always to a review against applicable company, securities and takeover laws). These rights may be set out in the issuer's articles of association or in a standalone agreement.

Trends and Developments

Contributed by:
Enda Garvey, Brian McCloskey and Robert Maloney Derham
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Matheson LLP has the leading private equity practice in the Irish market, with unrivalled expertise advising on the sponsor's entire capital life cycle – from fund formation, fundraising and raising leveraged finance through to investment, asset management, and exit. Matheson's dedicated private equity team adopts a cross-sectoral approach, working closely with specialists in asset management, tax, antitrust, IT, IP, and banking and finance groups to deliver on mandates for a wide range of private equity clients. From six offices in Cork, London, New York, Palo Alto and San Francisco, the team acts for clients across the private equity spectrum (including sponsors, target companies, and founder and management teams) and services clients in all geographies who are active in the Irish market. With a growing team of more than 560 legal, tax and digital services professionals, Matheson has significant bench strength, including sector-specialist lawyers across all areas who have a detailed understanding of the private equity industry.

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General Overview

The Irish private M&A market has remained resilient into 2024, despite a continuing global backdrop of negative economic and geopolitical factors and a slowdown in M&A activity globally. In 2023, even though there was a decrease in the value of Irish M&A deals year on year, deal volume remained broadly in line with 2022 levels. By contrast, in the first half of 2024, there has been a 20% decrease in deal volume against the same period in 2023. However, thanks to a number of deals transacted at the upper end of the valuation spectrum (ie, more than EUR500 million), Ireland's deal value figures have remained remarkably robust – with an increase of more than 200% against the same period in 2023. These trends compare favourably with wider European and global markets. Consistent with previous years, the most active segment of the Irish market in 2023 and the first half of 2024 continued to be the mid-market (ie, deals between EUR5 million and EUR250 million).

While overall activity levels remain strong, the continued prevalence of macroeconomic factors such as high interest rates, inflation and geopolitical instability has – unsurprisingly – resulted in deal-makers becoming more cautious as a result of the impact that these factors have had on fundraising conditions. The secondaries market, in particular, has continued to shift in a more "buyer-friendly" direction as a result. Although buyers are still prepared to offer competitive valuations for successful businesses, buyer-favourable purchase price mechanisms such as completion accounts adjustments, hold-backs, escrows and earn-outs have become more common than in previous years, as buyers seek to "test" their valuations and avoid over-paying for the assets being acquired.

2023 saw a year-on-year decrease in the number of M&A transactions involving private equity funds and this is attributable to the above-mentioned macroeconomic factors. So far, 2024 has seen strong levels of activity from both international and domestic private equity buyers. In the first half of 2024, almost one in five deals has been undertaken by a financial sponsor or a private equity-backed company and – notably – half of Ireland's largest 20 deals involved a private equity acquirer.

Consistent with previous years, technology, media and communication, e-commerce and financial services, and energy and infrastructure have seen significant levels of activity so far in 2024. Against the backdrop of the foregoing macroeconomic environment, a number of sector-specific trends have come to the fore in 2024 and represent a continuation of the trends identified in the latter half of 2023, as this article shall detail.

Increased Strategic Importance of ESG Considerations in M&A

The importance of ESG factors has increased across all sectors in recent years, as regulators seek to hold investors – and, indeed, all companies – to a higher standard. ESG considerations are now commonly an area of focus in private equity transactions and frequently form part of the due diligence process, whereas previously they were considered at a much later stage (if at all). Increasingly, private equity investors are utilising their individual portfolio companies to contribute towards and achieve their overall ESG targets. This is reflected not only in increased due diligence, but also in business plans agreed between investors and management.

Investors that fully grasp ESG requirements and understand the risks inherent across their

portfolio companies will not only be able to outmanoeuvre their competition by identifying and avoiding such risks but will also be in a strong position to use ESG disclosures to evidence their sustainability attributes. This serves both as a means for investors to meet and exceed their regulatory obligations and as a way of attracting higher valuations for portfolio companies based on sustainable business practices, which are increasingly recognised as drivers of long-term value. This has seen the general attitude towards ESG in the private equity market shift from being perceived as a risk management issue to a value driver.

The foregoing is not to say that ESG regulations represent an existential threat to laggards. Ireland will have until 29 May 2026 to implement the Energy Performance of Buildings Directive (EPBD) recast into Irish law. The EPBD introduces Minimum Energy Performance Standards (MEPS), which – if not met – will lead to real estate and other real assets becoming stranded as a result of decreasing valuations. This illustrates that ESG compliance is now a strategic imperative for investors and something that mandates not only adherence but achievement, so as to safeguard investment in the long-term.

The EU's Corporate Sustainability Reporting Directive (CSRD) has recently been transposed into Irish law. The CSRD introduced the EU's new mandatory sustainability reporting regime, which many Irish companies will be required to comply with in respect of their next financial year. Portfolio companies are preparing for reporting under the new regime and their financial sponsors are considering both how to incorporate the wealth of new non-financial reporting that will be required into their existing metrics, as well as the challenges that will arise for new acquisitions, where the target does not report under the CSRD or has different or potentially outdated reporting structures.

Private equity firms with larger portfolio companies are also considering the impact of the Corporate Sustainability Due Diligence Directive, which came into law in the EU in the middle of 2024 and will begin to apply to companies in 2027. Under this new regime, in-scope companies (and, indirectly, their customers and suppliers) will be required to incorporate sustainability due diligence into their operations and strategy.

Given the profusion of ESG-focused regulation detailed here, private equity investors are increasingly minded – with good reason – to consider the incorporation of ESG factors into their post-merger integration planning. Given the variety of possible approaches to ESG, aligning the strategies of the buyer and the target can be a cumbersome task and one that requires a cross-functional team effort.

Investment Limited Partnerships

Ireland has now seen the establishment of more than 50 Investment Limited Partnerships (ILPs) by private asset managers. This represents a steady increase since the updates to the new limited partnership regime in 2021. The ILP was designed to be a market-leading vehicle as compared to similar vehicles, such as the UK private fund limited partnership, the Luxembourg special limited partnership (société en commandite spéciale, or SCSp), the Delaware limited partnership, or the Cayman exempt limited partnership.

The ILP has a lot of similarities in terms of key features that investors have come to expect from similar fund structures – for example, the ILP:

- is a tax-transparent vehicle;

- retains confidentiality of the identity of limited partners; and
- is not subject to the legal and other requirements that apply to incorporated vehicles.

Some key distinguishing features of the ILP, compared to fund structures in other jurisdictions, are:

- the ILP's ability to be structured as an umbrella fund with separate sub-funds, with segregated liability between those sub-funds;
- the lack of requirement for the general partner to be located in Ireland and be a corporate vehicle; and
- the regulation of the ILP using Ireland's existing flexible, fast and robust Qualifying Investor Alternative Investment Fund (QIAIF) regime, which has been in use for more than 15 years and includes a 24-hour approval filing process.

The ILP regime is now tried and tested and the feedback from managers and investors regarding their experiences with the new structure has been very positive, both with the legal and tax structure itself and the pragmatic approach experienced in establishing and maintaining an ILP in Ireland as compared to other jurisdictions. Further interest from financial sponsors and a continued increase in the number of ILPs established are expected as information regarding the benefits of the ILP structure continues to permeate the industry.

Increase in Number of Asset Sales in the Form of Business Carve-Outs

In Ireland, the vast majority of private equity M&A transactions are structured as share sales rather than asset sales. However, there has been an increase in the number of pre-sale restructures and carve-outs in the market as a result of the market conditions identified earlier in the article. Notably, there has been a slight increase in the number of asset sales in the form of business carve-outs where certain large corporates seek to focus on their core business lines and dispose of non-core assets. Asset purchases and business transfers can be more appropriate where a specific part of the target's business is being acquired and therefore needs to be carved out from the larger business.

The biggest impediment to private equity portfolio companies pursuing carve-out deals is competition from strategic buyers. Owing to their existing infrastructure and scale, strategic buyers can often outbid their private equity competitors and offer the target a more streamlined acquisition process.

Use of Generative AI

As is the case across all sectors, the ability of generative AI to streamline procedures when it comes to deal-making is an issue that is increasingly coming to the fore. According to Mercer Investments' AI Integration in Investment Management 2024 Global Manager Survey, 26% of asset managers are currently using generative AI in the deal-making process, with another 51% planning to do so in the future. This indicates that, even though generative AI is used in the market, it is far from common practice at this stage.

Given the data heavy nature of investment analysis, generative AI is a useful tool in sourcing deals and easing the burden of the due diligence process. However, the issues of data security, data bias, and susceptibility to cybercrime continue to impede the ability of investors and their law firms to fully harness the potential of generative AI in deal-making processes.

The use of generative AI also raises issues in terms of regulation. On 21 May 2024, the EU Council approved the EU Artificial Intelligence Regulation (the "AI Act"). The AI Act is being introduced on a graduated basis and will be fully in force in Ireland by mid-2027. The increased regulation of the use of AI places a greater burden of compliance upon those companies who harness generative AI technology. Under the AI Act, failure to comply with such compliance requirements can lead to significant financial penalties.

As private equity firms implement AI technology within their own operations, there is an increasing expectation that it be used to streamline legal work associated with their transactions. This places an onus on law firms to adapt their procedures and processes in a responsible manner to ensure that their work benefits from the efficiencies of AI while at the same time ensuring that appropriate safeguards are in place.

Increase in Minority Investments by Financial Sponsors

Minority investments undertaken by financial sponsors have increased in Ireland in recent years. This trend is expected to continue as dedicated minority funds enter the market, both at a local and international level.

There are a variety of capital structures used, ranging from ordinary equity investments with certain control rights to preferred equity or debt-like structures with limited governance rights but with the ability to participate in equity returns. Mezzanine debt and convertibles instruments have also become more common in the Irish market. Typically, a financial sponsor who is taking a minority position will seek certain rights and protections including tag-along and drag-along rights, information rights, rights of first refusal in respect of new equity or debt issuances, and board appointment rights.

It is important that a well-negotiated shareholders' agreement is put in place to ensure a minority investor obtains adequate protection – albeit in a way that does not unduly stifle the development of the relevant business.

Typically, a private equity investor taking a minority position will invest directly through an existing entity rather than investing through a newly established Irish special purpose vehicle. A minority private equity investor will be unlikely to have full board control. As such, the financial sponsor is typically much more focused on veto rights and, in particular, veto rights relating to new equity/debt issues, budget control and acquisitions and disposals.

From a tax structuring perspective, the availability of Ireland's "substantial shareholders" exemption should be borne in mind in the context of minority investments, as this relief from Irish capital gains tax only applies where a minimum 5% shareholding has been held for a specified holding period.

Prevalence of W&I Insurance

Although initially most frequently used in private equity transactions, W&I insurance has now become prevalent across the entire M&A market. Having experienced a period of sustained growth for a number of years, the rate of that growth appears to have slowed during the course of the past 12 months. This slowdown is more likely reflective of a period of reduced deal flow, rather than being indicative of attitudes towards W&I insurance itself. Increased importance has also been placed on the role of the W&I broker as underwriters become slightly more risk-averse in the recent macroeconomic climate and pri-

vate equity sponsors seek increasingly bespoke protections.

The use of W&I insurance is particularly prevalent where financial sponsor-backed companies are involved. In contrast with trade sellers, such entities generally prefer a locked-box pricing mechanism over completion accounts and tend to use W&I insurance as a means allocating contractual risk in transaction documents.

Financial sponsor sellers will typically only give fundamental warranties in respect of title and capacity. Although the target's senior management team will provide a certain level of warranty cover in respect of warranties, the liability cap for such management warranties will usually be significantly lower than the overall purchase price, and W&I is now frequently employed to bridge the gap in risk cover.

On the other hand, trade sellers will ordinarily be expected to provide both fundamental and commercial warranties – although there had, until recently, been a considerable reduction in liability caps for commercial warranties in certain trade sales due to increased competitivity in the market. While the market has softened in the past 18 months (from the post-pandemic period), sellers of attractive businesses via auction processes are still able to leverage their position in order to limit their overall warranty risk.

One area in which there has been increased activity in the W&I insurance market is the use of W&I products to bridge the gap between the market approach to transactions in Ireland and the USA. The general approach to policy considerations in Europe and the USA has generally differed in the areas of disclosure, materiality, the basis of damages, warranties, the de minimis amount on the policy, and the due diligence processes required.

As the market has developed, a European/US hybrid approach to W&I coverage has emerged, whereby insurers in Europe are willing to apply enhancements to their European-style W&I policies to adopt some of the more bespoke approaches that are typically viewed as a hallmark of US W&I. Such enhancements will often (though not always) result in a higher policy premium and tend to be presented to clients as a menu of options from which certain desirable enhancements to a European-style policy can be chosen. This is particularly attractive to US buyers of European targets, as they tend to require W&I cover to be in a form that reflects the pre-purchaser style more familiar to them in the US market.

Generally speaking, the allocation of risk in private M&A transactions is more balanced than in previous years. By way of example, caps on liability in respect of fundamental warranties tend to be limited to the total consideration received by the sellers. On the other hand, caps relating to business/general warranties range between 20% to 100% of total consideration, with the majority of deals falling somewhere between 30% and 50% of the total consideration.

De minimis caps are typically fixed at around 0.1% of the purchase price, with basket caps at approximately 1% of the purchase price.

Key Areas of Negotiation

In recent years, a significant proportion of loans – particularly those exposed to the retail, hospitality, tourism, aviation and student accommodation sectors – have been subject to a mix of payment breaks, financial covenant waivers, covenant deferral periods, and longer-term cov-

enant re-sets. In the authors' experience, lenders and borrowers have sought to work together in a constructive manner to find solutions to work through that difficult period.

Recently, the rising interest rate environment has led to hedging requirements being a key area of focus for lenders. With many deals coming under pressure from an interest cover perspective, this is leading to negotiations over increased amortisation or debt paydown.

Financial covenants (and cures to any covenant breaches) are invariably a key area of negotiation, along with assignment and transfer provisions (and, in particular, the scope of white-lists/black-lists). Accordion facilities, options to extend the term, and the mechanics around exercising these options also tend to be closely scrutinised. Another area where there has been increased focus is the inclusion of green and sustainability-related provisions.

Conclusion

As corporate buyers and private equity firms are afforded greater visibility in respect of interest rate trajectories, with inflationary fears beginning to subside and with lenders' appetite for funding M&A increasing, there is a sense of cautious optimism that M&A opportunities will improve during the course of 2024. Certainly, where private equity funds have greater certainty around financing costs and access to debt, an increase in the number of sponsor-led transactions can be expected during the second half of the year.

With more than 50 ILPs now established in Ireland and the positive feedback from managers and investors concerning their experiences with the new structure, the new ILP regime is expected to cement Ireland as a key jurisdiction for private equity, real estate and infrastructure fund formation going forward.

In Ireland, the sectoral trends witnessed during the past few years across the wider M&A market — with technology, financial services and energy and infrastructure to the fore – will remain important sectors for M&A activity in 2024, as those sectors continue to perform well and grow. The ongoing digitalisation of businesses across a range of sectors, the green transition, and the need for corporates to invest in new capabilities to drive growth will undoubtedly continue to attract interest from financial sponsors and drive further M&A activity.

JAPAN

Law and Practice

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Mori Hamada & Matsumoto has a corporate M&A team that consists of approximately 200 attorneys. The firm has offices in Tokyo, Osaka, Nagoya, Fukuoka, Takamatsu, Sapporo and Yokohama, and international branch offices in Singapore, Shanghai, Beijing, Bangkok (Chandler MHM Limited), Yangon, Ho Chi Minh City, Hanoi, Jakarta, Manila and New York. The firm's M&A practice handles mergers, acquisitions, restructurings and corporate alliances in a wide variety of industries and sectors, including domestic and cross-border transactions (inbound and outbound); listed company, private equity and venture capital transactions; friendly and hostile transactions; going-private transactions; MBOs; acquisition finance; and takeover strategies. The firm has been particularly active in cross-border transactions involving Japan and South and South-East Asian countries. The firm's M&A team liaises with other key practice areas for M&A transactions involving distressed or insolvent companies, as well as M&A-related litigation and arbitration.

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MORI HAMADA & MATSUMOTO

1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

According to RECOFDATA, the number of Japanese M&A transactions announced in the first half of 2024 hit a record high of 2,321 with a deal volume of JPY9.8 trillion, which was an 19.4% increase and a 11.3% increase, respectively, compared to the first half of 2023.

Despite the weak Japanese yen, there has been a recovery in outbound M&A deals by Japanese companies after a rapid decrease in cross-border transactions and a slowdown in outbound M&A deals in 2020 due to the COVID-19 pandemic. The deal volume of outbound transactions by Japanese companies in the first half of 2024 was JPY4.5 trillion, a 48% increase compared to the first half of 2023.

While the deal volume of M&A transactions in Japanese target companies by financial sponsors decreased compared to the first half of 2023 (which was a record high in the last 40 years, mainly due to the public-to-private transaction of Toshiba for JPY2.1 trillion), the number of such M&A transactions increased by 14% compared to the first half of 2023. Notable deals include the public-to-private transaction of Infocom Corporation launched in June 2023 by Blackstone for JPY275 billion and the public-to-private transaction of KFC Holdings Japan, Ltd. launched in May 2024 by Carlyle for JPY135 billion.

1.2 Market Activity and Impact of Macro-Economic Factors

Active Sectors

According to RECOFDATA, the most active sector in terms of deal volume in the first half of 2024 was the software and information technology sector, with the deal volume of M&A transactions of Japanese target companies by financial sponsors in the sector reaching JPY382 billion. M&A transactions in the chemicals and electronics sectors have also been active in the first half of 2024.

Impact of Macro-Economic Factors

In response to the Japanese government's policy to reduce the number of listed companies that are subsidiaries of listed parents, the last few years have seen an increasing number of domestic deals where the parent of a listed subsidiary either buys out the subsidiary or sells its holdings in the subsidiary to a third party.

In addition, Japan has seen a number of corporations reorganising their businesses to improve capital efficiency, in response to increasing pressures from investors and the Tokyo Stock Exchange to focus on the cost of capital and the return on equity. Certain Japanese companies have sold their non-core businesses in order to refocus their resources on future growth areas to ensure long-term sustainable success, generating value for shareholders and contributing to the wider society. As a growing number of Japanese companies adopt the strategy of selling unprofitable sectors of their business portfolio and acquiring new businesses to ensure sustainable growth amid the rapidly changing business environment, this trend of deals driven by the need to change or diversify business portfolios looks set to continue.

In the small to mid-cap market, domestic M&A deals of family-owned businesses are likely to continue as founders have difficulty in handing over their business to family members or employees and instead decide to sell the business to third-party buyers, including private equity buyers.

Another interesting and important development in recent years has been an increasing number of hostile transactions, including unsolicited tender offers by Japanese companies, which have historically been very cautious about making such offers.

While Japan is politically stable, Japanese companies are affected by the global geopolitical tensions caused by the invasion of Ukraine and deteriorating US-China relations. Global inflation is having an impact on costs for business and higher interest rates will bring down valuations. However, these uncertainties do not seem to have materially hindered private equity deal activities in Japan – see **1.1 Private Equity Transactionsand M&A Deals in General**. Factors such as the ongoing very low interest rates and the continuously weak yen, as well as Japan's geopolitical stability with international investors facing difficulty making new investments in elsewhere in Asia, may have contributed to this trend. However, it is worth noting that some portfolio companies of private equity sponsors have faced financial difficulties and underwent restructuring proceedings in the last few years.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

New Guidelines

Corporate Governance Code and Stewardship Code

As part of the continued efforts to enhance the corporate governance of Japanese listed companies, the Tokyo Stock Exchange adopted the Corporate Governance Code in 2015, and revised it in June 2018 and June 2021. The Corporate Governance Code adopts the "comply-or-explain" approach and sets forth principles for effective corporate governance for Japanese listed companies, which, among other things, require listed companies to give weight to the cost of capital in determining their business portfolio and resource allocation. The emphasis on the cost of capital may encourage Japanese listed companies to dispose of their non-core businesses and focus on expanding their competitive edge through M&A.

In addition, the Japanese Financial Services Agency (FSA) introduced a Japanese version of a Stewardship Code in February 2014 and subsequently revised it twice, in May 2017 and March 2020. The Stewardship Code describes the principles considered to be helpful for institutional investors in fulfilling their stewardship responsibilities towards their clients, beneficiaries and companies when they engage with corporates. The FSA announced that 334 institutional investors have adopted the Stewardship Code as of 30 June 2024.

In the latest revised code, it is stipulated, among other things, that institutional investors should disclose not only the voting records for each investee company but also the reason why they voted for or against each agenda item, and that proxy advisers should dedicate sufficient management resources to ensuring sound judgement in the evaluation of companies and furnishing their services appropriately. These developments are affecting the stewardship activities of institutional investors, including the exercise of voting rights, which is also affecting M&A practices in Japan.

More than ten years after it formulated guidelines for management buyouts in 2007, the Ministry of Economy, Trade and Industry of Japan (METI) released fully revised guidelines for M&A transactions involving conflicts of interest in June

2019, titled the Fair M&A Guidelines: Enhancing Corporate Value and Protecting Shareholders' Interest (the "Fair M&A Guidelines"), which cover not only management buyouts but also acquisitions of a controlled company by a controlling shareholder.

Private equity M&A in which incumbent management participates (management buyouts) will be within the scope of the Fair M&A Guidelines; as a practical matter, compliance with the guidelines is likely to have an impact on appraisal rights litigation brought by shareholders who dissent to squeeze-outs.

Furthermore, in response to the increase in hostile or unsolicited offers and the court rulings on defence measures, on 31 August 2023 METI published new guidelines titled the Guidelines for Corporate Takeovers with respect to the principles and best practices of directors' conduct in the context of acquisition of corporate control of a listed company, which, among others, recommend that a phase-based approach be taken by the board against a proposal for acquisition of corporate control, and that an individual director, upon receipt of an acquisition proposal, promptly report it to the board and the board give "sincere consideration" to any "bona fide offer". When the board decides to negotiate towards agreement, the Guidelines request that the directors negotiate diligently with the acquiror to improve the offered terms so that the acquisition is conducted on the best available terms for the shareholders. The Guidelines have had a material impact on the attitude of the board as it can no longer ignore an offer solely because it is unsolicited.

Expected Change in Mandatory Tender Offer Rules and Large Shareholding Reporting Requirement

The Diet approved the amendments to the mandatory tender offer rules and large shareholding reporting requirement in May 2024. Once the amendments come into effect, a tender offer requirement will be applicable to any market trades (while currently, market trades (on-floor transactions) is exempt from the requirement), and the threshold of the mandatory tender offer will be lowered to 30% from the current one-third threshold by taking into account the actual ratios of voting rights exercised at Japan's listed companies. The amendments on the large shareholding reporting requirement include clarifications on which cases are exempted from the shareholders' agreement on joint exercise of voting rights and other shareholders' rights and thus the relevant shareholders are deemed joint holders (the details of which will be set forth in the relevant regulations before the amendments come into force). These amendments will come into effect no later than May 2026.

Foreign Investment Regulations

Expanded scope of foreign investment review

In 2020, there was a major amendment to the Foreign Exchange and Foreign Trade Act (FEFTA), which regulates foreign direct investments in Japan, among other things. While Japan has long required foreign investors to make a prior notification and undergo screening prior to investing in designated business sectors, the amendment expanded the scope of covered transactions.

As a result of the amendment, the threshold for the prior notification requirement for the acquisition of shares of listed companies engaged in designated business sectors was lowered from 10% to 1%, while any acquisitions of shares

of non-listed companies engaged in designated business sectors continue to be reportable regardless of the percentage of shares acquired (ie, the acquisition of even one share is reportable).

To strike a balance, the amended FEFTA concurrently introduced exemptions from the prior notification requirement, which may be available for passive investors who are not related to any foreign governments, if they comply with certain exemption conditions to ensure that they remain passive investors. Such exemption conditions include requirements to not:

- cause their closely related persons to become a board member of the target;
- propose to the shareholders' meeting any transfer of business in any designated business sector; and
- access any non-public technology information of the target relating to any designated business sector.

It should be noted that, because of these exemption conditions, the exemption is typically not available for a private equity buyer who intends to obtain control of a Japanese target.

Under the amended FEFTA, the designated business sectors triggering the prior notification requirement are classified into core sectors and others, where the core sectors cover more sensitive sectors such as weapons, dual-use technologies, nuclear, aircraft, certain forms of cybersecurity and telecommunications. If the target engages in a core sector business and is a non-listed company, no exemption is available. If the target engages in a core sector business but is a listed company, then the exemption will be available if the foreign investor is a regulated financial institution, or if the acquisition of shares is limited to less than 10% and the foreign investor complies with even more stringent exemption conditions.

Asset transactions (including statutory demergers and mergers) will also trigger the prior notification requirement under the amended FEFTA if it is an acquisition of a business in any designated business sector from a Japanese company by a foreign investor.

Review on exercise of voting rights

Under the amended FEFTA, a foreign investor is also required to make a prior notification before it exercises its voting rights at the shareholders' meeting of a Japanese company engaged in any designated business sector to:

- approve the appointment of the foreign investor or its closely related person as a board member of the target; or
- approve a transfer of business in any designated business sector, if the agenda is proposed by such foreign investor.

Continued addition of designated business sectors

The list of designated business sectors subject to screening is continuously reviewed and new sectors are added from time to time. For example, manufacturing of medicines against infectious diseases and high-risk medical devices was added in 2020 in response to the pandemic.

More recently, in 2023, in tandem with the government's efforts to secure a stable domestic supply of certain critical materials through the Act on Promotion of National Security through Integrated Economic Measures (the "Economic Security Promotion Act"), business sectors relating to these critical materials were added to the list. As a result, while the government will

provide subsidies to domestic suppliers of the critical materials under the Economic Security Promotion Act, it will also review foreign investments in these critical materials.

Stricter review

The Japanese government has continued to tighten its review of foreign direct investments, and this tendency will certainly continue following the war in Ukraine and heightened tension between Western countries and Russia and China. Foreign investors are recommended to analyse the implication of the FEFTA process on any deal-making in Japan at the outset of a potential transaction, especially if the investor is from China, Russia or other countries with which Japan has strained relations, or if it is funded or otherwise closely related to a foreign government.

Further amendment expected

Five years shall have passed in 2025 since the amendment of the FEFTA in 2020, and the government is committed a review of the framework under the FEFTA for any necessary updates or improvements.

Change in Tax Law

Stock-for-stock acquisitions

There were several M&A-related tax amendments in 2021, which could have a significant impact on M&A structuring. Among others, there were amendments to the taxation of stock-for-stock acquisitions.

A number of legal and tax changes have been made to facilitate stock-for-stock acquisitions by Japanese companies, and an increase in such acquisitions is expected. Not all private equity buyers would be able to propose a stock-for-stock acquisition, but these tax changes will add more options for acquisition consideration and could affect the competitive landscape in the M&A market.

Under the Companies Act, there is currently a transaction called a “Stock-for-stock Exchange” (*kabushiki kokan*), which can only be adopted when the acquirer intends to acquire all the issued shares of the target. An acquisition of only part of the issued shares of the target in exchange for the acquirer’s shares (eg, an exchange offer for a listed target) is theoretically permissible under the Companies Act by means of issuance of the acquirer’s shares in exchange for an in-kind contribution of the target’s shares. However, it is subject to a requirement that a court-appointed inspector investigates the value of the target’s shares prior to the issuance of the acquirer’s shares, and the target’s shareholders receiving the acquirer’s shares must indemnify the acquirer if it later turns out that the value of the target’s shares falls significantly short of the value on which the issuance of the acquirer’s shares was based. Such requirement tends to be prohibitively burdensome.

As part of the amendments to the Companies Act promulgated in December 2019, a transaction called a “Share Delivery” *(kabushiki kofu)* became available from March 2021, which allows a Japanese corporation to conduct a similar share exchange transaction with another Japanese corporation without the need for approval of the acquisition plan if the target is not a subsidiary of the acquiror prior to the transaction, but will become a subsidiary following it. Furthermore, tax law was amended in April 2021 to grant tax deferral on capital gains on the stock consideration received as a result of a Share Delivery, as far as the acquiror’s shares account for 80% or more of the total consideration.

Exercise of tax-qualified stock options upon M&A made easy

In 2024, there was a tax amendment to facilitate acceleration of tax-qualified stock options upon an M&A (trade sale). Prior to the amendment, a holder of a stock option was required to deposit the shares acquired through the exercise of the stock option to a securities company until the sale of the shares, even if the shares are unlisted, in order to secure the tax-qualified status of a stock option exercised upon an M&A. As a result, in an M&A where the stock options will be exercised and the shares acquired through the exercise will be sold to the purchaser momentarily after the exercise, the engagement of a security firm was still required for that momentary deposit. Together with the fact that not many security firms accept a deposit of unlisted shares, this made the exercise of stock options upon an M&A cumbersome. Following the amendment, while the deposit of shares will still be required, the deposit can be made to the issuer and managed internally without engaging a third-party security firm, which is expected to facilitate the exercise of stock options upon M&As, such as trade sales of start-ups.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Under the Act on Prohibition of Private Monopolisation and Maintenance of Fair Trade (the "Anti-Monopoly Act"), the acquisition of a company or business with Japanese domestic turnover can be subject to pre-transaction notification to – and clearance from – the Japan Fair Trade Commission (JFTC).

A stock acquisition is subject to such requirement if:

- the acquirer holds 20% or less of the voting rights prior to the transaction, but will hold more than 20% of the voting rights thereafter; or
- the acquirer holds 50% or less of the voting rights prior to the transaction, but will hold more than 50% of the voting rights thereafter; and
- the consolidated domestic turnover of the ultimate parent company of the acquirer (without taking into account the turnover of the target and its subsidiaries) exceeds JPY20 billion; and
- the consolidated domestic turnover of the target exceeds JPY5 billion.

There are comparable rules (with slightly different turnover thresholds) that apply to asset acquisitions, mergers, demergers and other types of business combination transactions. Depending on the fund structure, the domestic turnover of the portfolio companies of a private equity fund may be aggregated in applying the thresholds.

The statutory waiting period after the notification is 30 days, which may be shortened by the JFTC upon request, assuming there is no substantive competition issue. On the other hand, if the JFTC identifies any competition issue, it may extend the period and request additional information from the acquirer.

In addition to the mandatory filing, the JFTC recommends acquirers to consult the JFTC before the transaction if:

- the aggregate consideration of the transaction exceeds JPY40 billion;

- the thresholds for mandatory pre-transaction notification are met, except for the threshold pertaining to the consolidated domestic turnover of the target; and
- the transaction will likely affect domestic consumers – eg, if any one of the following is met:
  - (a) the target has offices, R&D facilities or other business operations in Japan;
  - (b) the target conducts sales activities targeting domestic consumers (eg, by maintaining a Japanese website or using Japanese brochures); and
  - (c) the target's consolidated domestic turnover exceeds JPY100 million.

As described in **2.1 Impact of Legal Developments on Funds and Transactions** (Foreign Investment Regulations), the jurisdiction of the FEFTA (which regulates foreign inward investments in Japan) is now very broad following its amendment.

A wide range of investments may be subject to the prior notification requirement. Furthermore, post facto reporting will be required in many cases, even if the relevant investments are not subject to the prior notification requirement, including when a foreign investor relies on the exemption from the prior notification.

Both the prior notification and post facto reporting will be submitted to the Bank of Japan, and will be circulated for review by the Ministry of Finance and other ministries supervising the industries in which the target engages. A statutory waiting period of 30 days will apply for a prior notification, which can be extended up to five months, but may be shortened if the investment does not relate to national security. A post facto reporting must be made within 45 days of the investment.

The FEFTA does not provide a stand-alone screening programme applicable solely to state-owned or sovereign wealth investors, but exemptions which may be available for other investors are not generally available for state-owned or sovereign wealth investors (see **2.1 Impact of Legal Developments on Funds and Transactions** (Foreign Investment Regulations)). The EU FSR regime is obviously not a major concern with respect to a Japanese target (unless it has operations in the EU).

Aside from the regulations under the Anti-Monopoly Act and the FEFTA, going-private transactions must comply with security regulations governed by the FSA, including the mandatory tender offer and disclosure requirements (see **7. Takeovers**), and the listing rules of the Tokyo Stock Exchange.

In response to the global trend of respect for human rights in corporate activities, METI released the "Guidelines on Respect for Human Rights in Responsible Supply Chains" in 2022. While global private equity players have already applied global human rights diligence requirements in their activities in Japan, the adoption of the Guidelines may require private equity investors in Japan to pay closer attention to the supply chain management of the targets of Japanese companies.

Following the war in Ukraine, the Japanese government adopted economic sanctions against Russia and Belarus, like many other countries. These sanctions and countersanctions on Russia are putting Japanese companies with Russian operations in a very difficult situation, which may in turn present the same difficult questions to private equity buyers when considering the acquisition of such companies.

4. Due Diligence

4.1 General Information

An acquirer typically conducts a due diligence investigation with the assistance of legal counsel and other advisers, and it usually covers business, legal, finance and tax matters. Of course, if the acquisition is made by way of an unsolicited offer, the acquirer would need to rely on annual reports and publicly available information on the target. However, it should be noted that Japan does not have a public database for litigation or lien searches, which limits the ability to conduct due diligence without the co-operation of the target.

A typical legal due diligence investigation of a Japanese target covers capitalisation, corporate governance, material contracts and assets, debt and other liabilities, employment, governmental authorisations, legal compliance, and litigation and disputes. For a private equity acquirer, the investigation of debt and material assets would involve analysis of the prepayment terms of existing indebtedness and consideration of a security package to be negotiated with the debt provider.

Corruption risks pertaining to business conducted in Japan are generally considered low, but the Japanese government is paying closer attention to the foreign corrupt practices of Japanese companies, and strengthening enforcement. As such, due attention should be paid to whether the target has sufficient systems in place to control foreign corruption risk.

Like many other jurisdictions, there is increasing business focus on customer and user data, which means that data protection compliance is becoming a new focus of legal due diligence.

4.2 Vendor Due Diligence

It is not common for a buyer to be able to see or rely upon a vendor financial due diligence report or vendor legal due diligence report, even in an auction sale. A vendor may conduct its own due diligence investigation in order to prepare for negotiations with potential buyers, but that is different from full-scale due diligence and the results would not typically be shared with potential buyers.

If a vendor were to provide a due diligence report to a potential buyer, it would usually be on a non-reliance basis only.

On the other hand, a buyer would usually be able to rely on due diligence reports prepared by its own advisers, but the buyer's equity and debt providers are not typically permitted to rely on reports prepared by the buyer's advisers.

5. Structure of Transactions

5.1 Structure of the Acquisition

The acquisition of a non-listed company by a private equity buyer would typically be structured as a stock sale, unless there is a specific reason to prefer an asset sale (eg, a high risk of hidden liabilities).

The acquisition of a business by a private equity buyer from a company, whether listed or non-listed, would typically be carried out in the form of a straightforward asset sale or statutory demerger (*kaisha bunkatsu*) under the Companies Act. The transferred assets and assumed liabilities can be specified in both scenarios, and there is no difference in the effectiveness of the separation of liabilities. It is not necessary to obtain consent from creditors in order to complete a statutory demerger. Instead, there are required

procedures that must be implemented to protect creditors and employees, which would take at least a month to complete.

A going-private transaction of a listed company would typically be carried out in a two-step acquisition, comprising a first-step tender offer and a subsequent squeeze-out transaction. See **7.6 Acquiring Less Than 100%** for details of the squeeze-out transaction.

A one-step cash merger is not typical, as it would trigger a revaluation of the transferred assets for tax purposes, and taxable income will be recognised on the difference between book value and fair value. In general, deal terms would be more competitive in an auction sale and there would be fewer representations and warranties made by the seller.

5.2 Structure of the Buyer

A private equity fund would typically form an acquisition entity, which is usually a corporation (*kabushiki kaisha*). As a general matter, a limited liability company (*godo kaisha*) could be used, but that is not usually an option because there is a legal hurdle for a limited liability company to enter into a commitment line agreement with banks to secure working capital.

Generally speaking, it is not common for a private equity fund to be a party to an acquisition or sale documentation, or to provide a separate guarantee.

5.3 Funding Structure of Private Equity Transactions

A private equity buyer would fund its acquisition entity with its own capital and with loans from banks, sometimes accompanied by mezzanine investments in the form of subordinated loans, preferred shares or convertible bonds. A private equity fund would typically acquire a controlling stake in the target, and the senior lenders will take security over material company assets.

In a tender offer, the acquisition entity will be required to provide evidence of its financing, both equity and debt, and must submit equity and debt commitment letters to the regulator, which will be publicly disclosed together with the registration statement. A seller in an auction process of a private target would also often require a private equity bidder to submit debt and equity commitment letters as part of the binding offer package.

Because debt financing has continued to be available in Japan due to the continued low interest rates, there has not been any material change in the market practice for the past 12 months.

5.4 Multiple Investors

Club deals are not frequently seen in Japan, partly because the deal size may not be as large as in the United States or some other jurisdictions. In a transaction with a large deal value, a consortium may be formed, as were the cases in the acquisition of Kioxia (then known as Toshiba Memory) by a consortium formed by Bain Capital and strategic investors (where the aggregate value of the equity and debt investments was approximately JPY2 trillion) and the public-to-private transaction of Toshiba launched in August 2023 by a consortium led by Japan Industrial Partners for JPY2.1 trillion.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

In Japan, both fixed price arrangements and completion account mechanisms with respect to consideration structures are commonly used in private equity transactions, while locked-box mechanisms are rare. Earn-outs are not frequently seen, but are sometimes used in the acquisition of pharmaceutical and start-up companies to bridge a valuation gap between the seller and the buyer resulting from the inherent uncertainty regarding the target's success. As discussed in **8.1 Equity Incentivisation and Ownership**, rollover-structures are sometimes seen in Japanese private equity deals.

Fixed price arrangements are common in relatively small transactions, or in transactions where the interim period between the signing and the closing is expected to be relatively short. In such cases, parties may want to minimise the administrative burden and expense of post-closing adjustments, and buyers tend to rely on interim covenants (covering conduct of business prior to closing) and representations and warranties (such as no material adverse effect after the latest financial statements date).

In transactions where there are completion account mechanisms, the purchase price is usually adjusted based on net indebtedness and net working capital.

In Japan, it is not common for private equity sellers to provide specific protections in relation to consideration mechanisms (such as adjustment escrows), and the terms relating to consideration mechanisms do not usually differ much from those with a corporate seller.

Private equity buyers cannot usually provide a guarantee to secure the obligations of the acquiring entity. To deal with their concerns regarding closing uncertainties in relation to financing, sellers often ask the buyer to submit binding debt commitment letters from banks prior to the execution of transaction documents (especially in an auction process). Equity commitment letters are less common but – specifically for going-private transactions, where tender offers are regulated under the Financial Instrument and Exchange Act (the FIEA) – a private equity buyer that is the tender offeror will be required to submit and publicly disclose equity commitment letters from its fund entities and debt commitment letters from its banks to show that it has secured sufficient funds to complete settlement.

6.2 Locked-Box Consideration Structures

As discussed in **6.1 Types of Consideration Mechanisms**, locked-box mechanisms, in the strict sense of the term, are rare in Japan. There are a number of transactions where the purchase price is agreed as a fixed amount and is not subject to any closing adjustment. However, in such transactions, there are no mechanisms for leakage indemnification or interest accrual on the purchase price; the protections for the buyer are typically the seller's interim covenants to conduct the target's business in the ordinary course and not to:

- distribute dividends;
- enter into transactions with the seller and its affiliates; or
- enter into other specified transactions.

6.3 Dispute Resolution for Consideration Structures

It is quite typical to have a dispute resolution mechanism in place for completion accounts

consideration structures. A typical dispute resolution mechanism would include:

- a good faith discussion period between the parties to resolve any differences; and
- determination by an independent third party (usually an accounting firm) if the parties are unable to reach agreement.

The selection of such third party is often agreed in the transaction agreement beforehand, or the parties can agree to each select an independent firm and use the average figure of both firms' results.

6.4 Conditionality in Acquisition Documentation

Closing conditions are usually heavily negotiated between the seller and the buyer, and it is difficult to generalise what is "market" because the outcome will largely depend on the specifics of the transaction.

In most cases, private equity sellers emphasise deal certainty and will therefore resist any closing conditions that are not within the seller's control, except for regulatory approvals, which are in most cases provided as a closing condition. Non-controllable conditions include:

- the buyer's financing;
- third-party consents;
- the absence of material adverse changes; and
- the retention of key personnel.

It is generally difficult for a private equity buyer to include financing as a closing condition, especially in an auction process. Other closing conditions do not generally differ much from the conditions provided for in transactions by a corporate buyer.

If the transaction involves a tender offer, conditions are kept to the minimum due to the rather stringent restrictions on withdrawing a tender offer, as further discussed in **7.5 Conditions in Takeovers**.

6.5 "Hell or High Water" Undertakings

"Hell or high water" undertakings are sometimes negotiated between the seller and the buyer, especially with respect to securing clearance under merger-controls, but are still not very common in Japan, regardless of whether the transaction involves a private equity fund as a buyer or not. Sellers would usually mitigate clearance risk through a simpler covenant obliging the buyer to use its best or reasonable efforts to obtain the clearance.

The EU FSR has not become a major issue in transactions involving Japanese targets.

6.6 Break Fees

Break fees payable by the seller are not common in private equity transactions without tender offers (see **7.5 Conditions in Takeovers** for transactions that involve tender offers), nor are fiduciary-out provisions. Reverse break fees payable by the buyer are also not common, but are used in some transactions where the seller is particularly concerned about the deal certainty. While it depends on the specificities of the relevant transaction, a typical trigger for a reverse break fee is the failure to obtain regulatory clearance and the amount is typically less than 10% of the transaction value.

There are no specific legal limits on break fees or reverse break fees, but they are usually structured as liquidated damages that would restrict a party from pursuing additional damages claims against the counterparty. Structuring them as a penalty (which does not preclude a separate

damages claim) is also possible, but such intention must be expressly provided in the transaction agreement.

6.7 Termination Rights in Acquisition Documentation

In general, termination events provided in the transaction documents for private equity sellers or buyers do not differ significantly from those for corporate sellers or buyers. Usually, the termination right is only exercisable before the closing of the transaction.

Typical termination events include:

- material breach of representations or covenants by the counterparty;
- the insolvency of the counterparty; and
- the passing of a long-stop date.

While it depends on the specificities of the relevant transaction, a long-stop date would be typically negotiated based on the anticipated timeline for securing regulatory clearances.

6.8 Allocation of Risk

Typical methods to allocate risk between the buyer and the seller in Japan do not differ substantially from general practices in other jurisdictions. Risks are allocated through:

- representations and warranties;
- pre- and post-closing covenants;
- closing conditions;
- indemnification; and
- post-closing adjustments of the purchase price.

Even when the seller of the target is a private equity fund, the seller's representations and warranties would usually include representations and warranties regarding the target's business, although the scope of such representations and warranties would be more limited compared to those that would be given by sellers that are not private equity funds.

Private equity sellers tend to avoid any post-closing exposures and to limit post-closing covenants and indemnification terms. Limitations on indemnification include short survival periods for representations and warranties (sometimes such survivals are less than a year after the closing) and limitations such as de minimis exclusions, deductibles or baskets, and caps on indemnity. Cap amounts negotiated by private equity sellers are often lower than those negotiated by corporate sellers.

6.9 Warranty and Indemnity Protection

As discussed in **6.8 Allocation of Risk**, even when the seller of the target is a private equity fund, the seller's representations and warranties would usually include representations and warranties regarding the target's business, although the scope of such representations and warranties would be more limited compared to those that would be given by sellers that are not private equity funds.

Also, representations and warranties given by private equity sellers are often qualified by materiality (which may be simple materiality or "material adverse effect") and seller's knowledge (actual or constructive). A private equity seller would negotiate anti-sandbagging provisions. Although there are a limited number of court precedents, it is generally understood that the courts could deny indemnification claims with respect to breaches of warranties known to the buyer at the time of execution of the transaction document if the transaction document is silent about sandbagging.

Exceptions to the representations and warranties are typically carved out by disclosure schedules, and sometimes by full disclosure of the data room. Limitations on indemnification include short survival periods for representations and warranties (sometimes such period is less than a year after the closing) and limitations such as de minimis exclusions, deductibles or baskets, and caps on indemnity. Cap amounts negotiated by private equity sellers are often lower than those negotiated by corporate sellers.

The management team of the target seldom provides separate representations and warranties to a buyer, unless the management team itself is a seller in the transaction.

6.10 Other Protections in Acquisition Documentation

While private equity sellers accept indemnification to a certain extent, a seller would negotiate to limit its exposure as much as possible, as explained in **6.8 Allocation of Risk** and **6.9 Warranty and Indemnity Protection**. There are cases where private equity funds agree to set up an indemnity escrow as the buyer's sole recourse, although such practice is still relatively rare.

While warranty and indemnity (W&I) insurance has been used by Japanese companies in cross-border M&A, historically, it had not been widely used in domestic M&A, partly because there was no insurance company capable of providing the insurance based on a Japanese language due diligence report and transaction documents.

However, an increasing number of Japanese auction sellers, including private equity sellers, are now requesting bidders to rely on W&I insurance in place of their recourses against the sellers. Furthermore, insurance companies have recently started to actively provide W&I insurance in Japan based on Japanese language documents. There has also been an increasing opportunity for providers of this insurance in connection with the increasing number of small to mid-cap M&A conducted for the purpose of "business succession".

As a result, W&I insurance is becoming more and more common even in domestic M&A and there have been many auction processes where the bidders are required to give up any recourse against the seller and instead rely on the representations and warranties insurance.

W&I insurance policies purchased for Japanese targets usually provide coverage for both fundamental and business representations and warranties.

6.11 Commonly Litigated Provisions

Breaches of representations and warranties, such as inaccurate financial statements, are often negotiated and disputed between the seller and the buyer following the closing. However, the parties tend to resolve such disputes outside court.

For a going-private transaction, it is not uncommon to see appraisal rights litigation initiated by dissenting shareholders who have been squeezed out.

7. Takeovers

7.1 Public-to-Private

Going-private transactions have been common in the Japanese M&A market. Management buyouts sponsored by private equity funds were very popular in the late 2000s and peaked in 2011. Management buyouts were not as frequent over the past decade, but there has been

an increasing number of management buyouts in the last few years.

Recent going-private transactions sponsored by private equity funds include:

- the acquisition of Hitachi Metals, Ltd. by a consortium made up of private equity firms Bain Capital, Japan Industrial Partners and Japan Industrial Solutions in 2022;
- KKR's acquisition of Hitachi Transport System, Ltd. in 2022;
- Bain Capital's acquisition of Nichiigakkan in 2020 and of Kirindo Holdings in 2021;
- the acquisition of Toshiba by a consortium led by Japan Industrial Partners in 2023; and
- the acquisition of JSR Corporation by Japan Investment Corporation in 2024.

In going-private transactions, the target company must, after the commencement of the tender offer, file a document stating its position (for, against or neutral) on the tender offer under the FIEA, and also make a public announcement regarding its position in accordance with the stock exchange's rules and regulations. The target company's directors must reach a decision on the company's position in accordance with their duties of care and loyalty. While permissible, it is not very common for the bidder and the target company to enter into an agreement regarding the tender offer. If such agreement is executed, it usually contains provisions obliging the target company to express its affirmative opinion regarding the tender offer. In such a case, the bidder and the target company would likely negotiate fiduciary-out provisions and break fees, whereby such an agreement must also be disclosed in the tender offer registration statement.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

The FIEA imposes a reporting requirement on holders of more than 5% of the shares of a listed Japanese company. In calculating the shareholding ratio, the number of shares held by certain affiliated parties and other shareholders who have made an agreement (with respect to decisions on the acquisition or disposition of the shares or the exercise of the voting rights) will be aggregated. See **2.1 Impact of Legal Developments on Funds and Transactions** (Expected Change in Mandatory Tender Offer Rules and Large Shareholding Reporting Requirement) for recent amendments. The reporting must be made to the relevant local finance bureau (*zaimukyoku*) within five business days of the 5% threshold being exceeded. Following the initial reporting, the shareholder must file an amendment whenever there is an increase or decrease in its shareholding ratio by 1% or more, or a change to the name, address or other material information in the previous reporting.

When commencing a tender offer, the offeror is required to file a tender offer registration statement with the relevant local finance bureau, which sets forth, inter alia, the offer terms, identity of the offeror, reason of offer, plan on squeeze-out, and measures taken to avoid any conflict of interest.

7.3 Mandatory Offer Thresholds

The FIEA sets forth mandatory tender offer requirements that apply to the acquisition of shares of listed companies (and non-listed reporting companies, which are rare). The rules are fairly complex, but the most important of the various requirements is a so-called one third rule, which requires a buyer intending to acquire shares of a listed company to conduct a tender offer if it intends to purchase shares off-market

and would acquire more than one-third of the total voting rights of the listed company as a result of such purchase.

It should be noted that the one third threshold is tested against the voting rights after the acquisition, and even an acquisition by a buyer not holding any voting right before the acquisition could be subject to the requirement; while the requirement will not generally apply to an on-market purchase of shares, it will apply to off-floor trading, which does not provide general market participants with an opportunity to be a party to the trading. The voting rights will be calculated in accordance with the detailed rules set forth in the FIEA, which include aggregation of the voting rights held by certain affiliated parties and other shareholders who have made an agreement (with respect to decisions on the acquisition or disposition of the shares or the exercise of the voting rights). Such affiliated parties and other shareholders who have made an agreement could include affiliated or related funds or portfolio companies of private equity-backed bidders.

The amendment to the mandatory tender offer rules will come into effect no later than May 2026, following which a tender offer requirement will be applicable to any on-market trading (while currently on-market auction trading is exempt from the requirement) and the threshold of the mandatory tender offer will be lowered to 30% from the current one-third threshold (see **2.1 Impact of Legal Developments on Funds and Transactions** (Expected Change in Mandatory Tender Offer Rules and Large Shareholding Reporting Requirement)).

7.4 Consideration

In almost all tender offers for Japanese targets, consideration has been cash only. Stock or mixed consideration has not been used, mainly because Japanese tax law did not grant a tax deferral on capital gains upon the sale of stock for stock or mixed consideration, which led dispersed shareholders of a listed company to face an immediate need for cash to pay taxes, and because the acquirer was subject to prohibitively burdensome requirements under the Companies Act, including an investigation by a court-appointed inspector into the value of the target's shares prior to the issuance of the acquirer's shares, and an obligation for the acquirer to indemnify the target's shareholders if it later turns out that the value of the target's shares they received was significantly less than the value on which the issuance of the acquirer's shares was based.

However, as discussed in **2.1 Impact of Legal Developments on Funds and Transactions** (Stock-for-stock acquisitions), there have been some legal and tax changes to facilitate stock-for-stock acquisitions by Japanese companies, and an exchange offer may finally come into play following such changes.

There are no minimum price rules applicable to tender offers in Japan.

7.5 Conditions in Takeovers

Offer conditions are strictly regulated, with the FIEA setting out the limited list of permitted conditions, including the occurrence of:

- a decision by the target to effect a merger, reduction of stated capital, issuance of new shares and other specified material corporate actions;
- the revocation of government authorisations held by the target, natural disaster and other specified material events relating to the target;

- the failure to obtain regulatory approvals; and
- the dissolution and bankruptcy of the acquirer.

Financing cannot be an offer condition, and the offeror must submit equity and debt commitment letters to the regulator as evidence of financing, which will be publicly disclosed together with the registration statement.

In order to secure successful completion of the tender offer, an offeror enters into an agreement with the principal shareholders frequently, and sometimes with the target, pursuant to which the offeror agrees to launch the tender offer in accordance with the agreed terms; in exchange, the target agrees to support – or the principal shareholders agree to tender their shares to – the tender offer so long as it is conducted in accordance with the agreed terms. In each case, the existence and contents of such agreement must be publicly disclosed in the registration statement. The target board would often negotiate a fiduciary-out clause in such agreement, and the offeror would negotiate a break fee in response.

7.6 Acquiring Less Than 100%

If an offeror wishes to acquire only a certain percentage of the shares of a listed company, it can generally set a cap for the acquisition in its tender offer. However, if the offeror will obtain two thirds or more of the total voting rights as a result of the tender offer, it cannot set any cap on its offer and must make an offer to purchase all the tendered shares.

If an offeror obtains 90% or more of the total voting rights of a listed company, it can squeeze out the minority shareholders by exercising a statutory call option available under the Companies Act. This requires approval from the board of the target (which can be controlled by the 90% shareholder), but not from the shareholders. Dissenting shareholders can exercise appraisal rights and can seek an injunction in limited circumstances (eg, when the exercise of the call option is in breach of law or when the call price is grossly improper).

If an offeror does not obtain 90% of the total voting rights but secures two thirds, it can still squeeze out the minority shareholders by alternative methods available under the Companies Act (all of which would require a two-thirds super-majority approval of shareholders). Such alternatives include a short-form cash merger, but a reverse stock split (*kabushiki heigou*) is the option predominantly used. The reverse stock split would be structured so that, following its completion, shareholders of the target other than the offeror would hold only fractional shares and would be subsequently cashed out. Dissenting shareholders can exercise appraisal rights and seek an injunction if the reverse stock split is completed in breach of the law or the articles of incorporation of the target, and the shareholders could be adversely affected.

Due to corporate governance concerns, it would be difficult for the target to grant a shareholder additional governance rights that are disproportionate to its shareholding. As such, it is typically not possible to obtain only a minority position or a limited number of shares of a listed company through a tender offer and concurrently negotiate additional governance rights.

Similarly, debt push-down into the target company is not common in Japan due to concerns regarding minority shareholder protection.

7.7 Irrevocable Commitments

If the target has a principal shareholder, it is customary for an offeror to enter into a ten-

der offer agreement with such principal shareholder at the same time as the announcement of the tender offer. In a tender offer agreement, the offeror agrees to launch the tender offer in accordance with the agreed terms, and, in exchange, the principal shareholder(s) agrees to tender its shares to the tender offer so long as it is conducted in accordance with the agreed terms. The tender offer agreement would usually include certain conditions to tender, and often a set of representations and warranties and indemnification provisions. In addition to such conditions to tender, the principal shareholder would sometimes negotiate an "out" for the tender obligation in case a better offer is made by a competing bidder.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

While cash compensation is a common form of incentivisation for the management team in private equity transactions, there are cases where equity incentives are provided to the management team. The level of equity ownership in such cases depends on various circumstances, but typically falls within a range of 5% to 20%.

8.2 Management Participation

Equity-based incentive schemes vary in structure, but are typically structured as a rollover of existing equity into new equity or a grant of stock options in either the post-buyout target company or its holding company. Typically, the management will subscribe for ordinary equity, and preferred instruments are not often used in the management equity structures.

In Japan, no specific tax rules apply to management rollovers (eg, tax-free rollovers) or parachute payments (eg, the prohibition of deduction for such payments and the imposition of excise taxes on such payments). Regarding stock options granted to individuals, "qualified stock options" (ie, certain qualified options that meet specific criteria) will be subject to tax at capital gains rates (about 20%) upon the sale of the underlying shares. In contrast, holders of non-qualified stock options are first taxed based on the economic gain reflected in the difference in the value of the shares underlying such options compared to the exercise price of the options at the time of exercise of the options; such gain is taxed as salary income (which would usually subject such holder to a higher progressive tax rate compared to tax at the capital gains rates). Such holders are taxed a second time at the time of sale of the shares underlying such options; the capital gains rate tax will apply on any increase in the value of the shares since the exercise of the options.

8.3 Vesting/Leaver Provisions

Typical leaver provisions for management shareholders would include good leaver provisions whereby the management shareholder is entitled to retain equity (eg, if the employment is terminated by the private equity fund without cause), and bad leaver provisions whereby the management shareholder loses its equity in the target company (eg, if the employment is terminated for cause or the management's breach of the employment agreement). In typical cases where the bad leaver provisions are triggered, shares are compulsorily transferred to the private equity shareholder at market price or the original issue price, and share options are waived and become no longer exercisable.

Vesting is usually tied to time or performance. Time-based vesting is generally linear and the typical vesting period is around five years. With respect to performance-based vesting, equity

will vest annually if a certain target is met (eg, EBITDA targets) or upon exit (ie, vesting will not occur before the exit, and the amount of equity to vest is tied to the sale price).

8.4 Restrictions on Manager Shareholders

Management shareholders are usually subject to restrictive covenants (non-compete, non-solicitation and sometimes non-disparagement undertakings) under the shareholders' agreements or executive services agreements with the private equity shareholder. Even where there is no express undertaking in such agreements, management shareholders who are directors will be subject to statutory non-compete obligations under the Companies Act of Japan and will be prohibited from engaging in transactions that belong to or are within the scope of the business of the target company, unless the target board approves such transactions. Whether any post-employment non-compete and non-solicitation obligations apply to such management shareholders will, in principle, depend on whether there is any express agreement binding such management shareholders.

Japanese courts will typically enforce post-employment non-compete obligations that extend for a period of one to two years, and in some instances even longer if there are rational reasons to uphold long-term non-compete obligations. Non-compete obligations that are determined to be overly broad and restrictive by the court will be rendered unenforceable. In determining the enforceability of particular non-compete obligations, the courts typically consider and weigh factors such as:

- the position and responsibility of the former managers;
- whether the former managers were adequately compensated; and
- the scope and breadth of the non-compete obligations.

8.5 Minority Protection for Manager Shareholders

In general, shareholders' agreements entered into between management shareholders and a private equity shareholder do not afford much minority protection for management shareholders. Normally, minority protections such as anti-dilution provisions, veto rights, director appointment rights or the right to control or influence the exit of the private equity shareholder are not provided for, unless the management shareholder is also the seller/founder of the company, in which case the founder management shareholder may have some veto rights and board appointment rights.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

A private equity shareholder would typically hold a majority of the voting rights and would accordingly have veto rights over certain fundamental corporate actions and events relating to the portfolio company that are subject to shareholder approvals, including amendments of articles of incorporation and mergers and other corporate reorganisations. The private equity shareholder would also be able to appoint and remove directors as a majority shareholder.

Furthermore, a private equity shareholder will enter into management services agreements with the key management members, and may control the individual directors through such agreements. The management services agree-

ment would set forth the roles and responsibilities of the key management members, compensation and certain reporting requirements, among other matters.

A private equity shareholder would also typically nominate one or more directors to serve in each portfolio company to facilitate its oversight of the portfolio company's business operations. Such directors would attend the board meetings at which material business issues and agenda items would be discussed and approved.

9.2 Shareholder Liability

Generally, a private equity fund majority shareholder will not be held liable for the actions of its portfolio company. However, in instances where it is unreasonable to treat the portfolio company as an independent juridical person, Japanese courts may apply the doctrine of piercing the corporate veil and deny the independent legal personality of the portfolio company, holding the shareholders liable for the liabilities of the portfolio company. According to judicial precedents, the doctrine requires that the legal personality either is abused to avoid the application of laws or has no substance.

10. Exits

10.1 Types of Exit

The typical holding period for a private equity fund is around five years. The most common form of private equity exit is through M&A, but IPOs remain an attractive option for private equity exits because a Tokyo Stock Exchange listing is available even to companies with relatively small market capitalisation. An M&A/IPO dual-track process (ie, running an M&A sale track alongside an IPO track) is sometimes seen in Japan, but is not as popular as in other jurisdictions. An M&A/IPO/recapitalisation triple-track process is not yet common in Japan. Reinvestment by private equity sellers upon exit is not common practice.

10.2 Drag and Tag Rights

Drag-along arrangements are typical in shareholders' agreements between private equity shareholders and management shareholders. While it depends on negotiations, drag-along rights of private equity funds can also be found in shareholders' agreements between private equity and institutional co-investors. Key terms of the drag rights are not substantially different from those agreed in non-private equity transactions. The typical drag threshold would be the sale of a controlling stake in the portfolio company.

In some cases, the drag-along rights of private equity shareholders are coupled with the management shareholders' tag-along rights, which may be exercised upon the sale of all or a controlling stake by the private equity fund. The thresholds of the tag rights are typically not substantially different between management and institutional investors.

10.3 IPO

Under the Tokyo Stock Exchange's listing rules, shareholders who were allotted shares within a one-year period prior to the last date of the business year immediately before the IPO application date are subject to a lock-up period of six months after the IPO (or one year after such allotment). In addition, underwriters will require major shareholders of the company to execute lock-up letters that prohibit the disposal of shares for a certain period after the date of the IPO (most commonly 180 days). After these lock-up periods, shareholders are allowed to freely sell the shares in the market.

In Japan, controlling shareholders and target companies will not enter into relationship agreements, but listing rules and disclosure requirements are designed to provide governance over the relationship between the controlling shareholder and the target company.

Trends and Developments

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Nagashima Ohno & Tsunematsu is the first integrated full-service law firm in Japan and one of the foremost providers of international and commercial legal services based in Tokyo. The firm's overseas network includes offices in New York, Singapore, Bangkok, Ho Chi Minh City, Hanoi, Shanghai and Jakarta, associated local law firms in Beijing and collaborative relationships with prominent local law firms in many other jurisdictions. In representing leading domestic and international clients, the firm has successfully structured and negotiated many of the largest and most significant corporate, finance and real estate transactions related to Japan. In addition to its capabilities spanning key commercial areas, the firm is known for handling ground-breaking domestic and cross-border risk management/corporate governance cases and large-scale corporate reorganisations. The firm has over 600 lawyers, who work together in customised teams to provide clients with the expertise and experience specifically required for each client matter.

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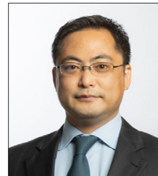

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Investment Deal Trends

The private equity market in Japan continued to be very active in 2023. While there is no official data on the number or type of transactions conducted by private equity firms, it is reported that a historically high number of private equity deals occurred in 2023. Since around 2015, the increase in private equity deals has mainly been driven by the expanding need to find successors for small to mid-size business owners. Recently, however, private equity deals are showing more diversity, such as carve-out deals, taking-private deals, including management buyouts (MBOs), and secondary buyout deals. This is strong evidence that private equity firms are now recognised in the Japanese market and are expanding their role in Japan.

Notable deals from 2023 include:

- the acquisition of Proterial, Ltd. (formerly known as Hitachi Metals, Ltd.) by Bain Capital in January 2023 for approximately JPY714 billion (going-private);
- the acquisition of ImpactHD Inc. by Bain Capital in March 2023 for approximately JPY22 billion (going-private);
- the acquisition of Iwasaki Electric Co., Ltd. by Carlyle in March 2023 for approximately JPY22 billion (going-private);
- the acquisition of Nichi-Iko Pharmaceutical Co., Ltd. by J-Will Partners in March 2023 for approximately JPY20 billion;
- the acquisition of Evident Corporation (science-related business of Olympus Corporation) by Bain Capital in April 2023 for over JPY400 billion;
- the acquisition of Toshiba Corporation by Japan Industrial Partners in September 2023 for approximately JPY1.5 trillion (going-private); and
- the acquisition of SI&C Co., Ltd. (formerly known as System Information Co., Ltd.) by Bain Capital in November 2023 for approximately JPY15 billion (going-private).

It is notable that Toshiba Corporation, one of the largest Japanese electrical manufacturers, was acquired by the consortium led by Japan Industrial Partners, a Japanese private equity firm, at over JPY1.5 trillion in order to escape pressures arising from overseas activist shareholders.

The secondary market and public-to-private transactions

While the number of public-to-private (P2P) deals decreased in 2023 compared with the previous year, around 16 P2P deals were closed in 2023. Given the high stock price of Japanese listed companies since 2023, the number of P2P deals might continue to decrease in 2024. However, activist shareholders have been active in the Japanese market recently, and there have been some deals in which private equity funds acquired listed companies having problems with activist shareholders as a kind of “white knight”. The acquisition of Toshiba Corporation, as mentioned above, is a good example of such a deal.

The number of hostile takeover deals has remained at a high level since 2018, and in 2023 only one hostile takeover deal failed. However, hostile takeovers have been publicly acknowledged as one of the legitimate acquisition methods to acquire a listed company in Japan and, given this position as stated in the Guidelines for Corporate Takeovers published by the Ministry of Economy, Trade and Industry (METI) on 31 August 2023 (as discussed below), the number of hostile takeover deals could increase in 2024.

In relation to the secondary market, in which private equity firms often sell their portfolio compa-

nies to each other, it is reported that there were around 13 deals in 2023. Although the number of M&A transactions being conducted by private equity firms in Japan is at an historical high, overall, the secondary market in Japan seems less active compared with the past year in which the number of secondary transactions was the highest for the previous five years.

Looking forward from 2023

While the economy was a little uncertain due to historically weak Japanese yen in 2023, M&A activities in Japan continued to be very active. This trend is expected to continue in 2024.

As the market is accepting unsolicited tender offers with high premiums, the small to mid-size listed companies will continue to be a target for unsolicited tender offers in 2024 and more listed companies may consider going private so that they can focus on the business.

Exit Trends

It is reported that the number of exit deals in 2023 sharply increased compared with 2022, which had the highest number of exit deals in recent years. In particular, there were ten initial public offering (IPO) exits in 2023. Given the high stock price of Japanese listed companies since 2023, it is expected that this exit trend will continue in 2024.

Fair M&A Guidelines

The Fair M&A Guidelines: Enhancing Corporate Value and Securing Shareholders' Interests, issued by METI have influenced M&A practice. In particular, following the publication of these guidelines, a trend has emerged where companies undergoing an M&A transaction establish special committees to examine the proposed transaction and such special committees become more deeply and actively involved at an earlier stage in MBO transactions in particular. However, not only is it becoming common for such special committees to be established for MBOs and in acquisitions of companies by their controlling shareholders, they are also being used in other public transactions involving squeeze-outs that are not directly covered by the these guidelines.

There were 16 MBO transactions announced in 2023, including the MBO transaction of Taisho Pharmaceutical, which is the largest MBO transaction in Japan in terms of deal value. It is expected that the number of MBO transactions in 2024 will exceed or stay on the same level as 2023. As many M&A transactions are being carried out by company management with the support of private equity (PE) funds as sponsors, the increasing number of MBO transactions may provide investment opportunities for PE funds.

Hostile Takeovers and Guidelines for Corporate Takeovers

Hostile acquisitions were long considered taboo in Japan. However, the number of hostile transactions has risen since 2019, and some have concluded successfully for the acquirer.

Consistent with this trend, the Guidelines for Corporate Takeovers published by METI on 31 August 2023 are playing a role in further increasing the number of hostile and unsolicited M&A transactions. The purpose of these new guidelines is to present principles and best practices that should be used throughout the business world to develop fair rules regarding M&A transactions. The new guidelines encourage more M&A activity targeting listed companies in Japan as they require, among other things, the board of directors of target companies to give sincere consideration to bona fide takeover offers.

Although there have not been any recent transactions where a private equity fund attempted to acquire a target company against the wishes of the target company's management and it would typically be difficult for private equity funds to pursue hostile or unsolicited takeovers due to their investment policies and the need to obtain external financing, the trend of increasing numbers of hostile takeovers has greatly affected investments by private equity funds.

Previously, in response to hostile acquisition bids, some target companies attempted to introduce "poison pill" defence measures, the validity of which was disputed before the courts. The courts tended to support the validity of such defence measures if the shareholders' meeting had approved their implementation. However, given that "poison pills" are not a perfect defence measure, the increasing number of activities by activist shareholders could potentially induce other types of acquisition investments by private equity funds, such as acquisitions as a "white knight".

Shareholder Activism

The presence of activist shareholders in Japan is growing. They are increasingly making various demands of the listed companies in which they hold shares (including dialogue with management), and often submit proposals and dramatically express opposition to company proposals at general shareholders' meetings. In particular, activist shareholders tend to target companies with a low price-to-book ratio (PBR).

In the context of M&A, there have been several recent instances where activist shareholders intervened in M&A deals for listed companies by announcing their opinion that the purchase price was too low or by buying up the target company shares themselves, resulting in the share price in the market exceeding the tender offer price and the tender offer being unsuccessful (such cases have also included MBO deals by private equity funds). Therefore, in going-private transactions by listed companies, especially in MBO transactions, it is necessary to fully consider the appropriateness of the price and the possibility of intervention by activist shareholders before proceeding with the transaction.

On the other hand, activists sometimes drove M&A deals by advocating for going-private transactions or divesture of assets or companies to enhance shareholder value.

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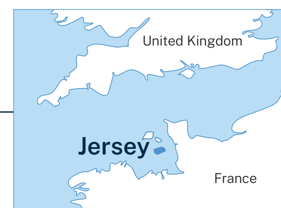

Law and Practice

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

Following this cycle's all-time peak, reached in 2021, the global M&A market turned in its second-weakest year in exactly a decade in 2023. However, the more normal deal activity levels seen in the latter part of 2023 have created an environment in which we are now seeing global M&A bouncing back in 2024.

As a well-regulated international finance centre, Jersey continues to deliver innovative and high-quality downstream acquisition and investment fund-structuring solutions to global private equity and sector-focused institutional sponsors.

In line with global market conditions, strong top-sponsor appetite remains for renewable energy/resources and infrastructure opportunities, which have greater potential for value creation over the life of an asset. Such transactions may involve more upfront cost and complexity. One key attraction for maintaining a stable of infrastructure assets is the "best in class" investor-return prospects that they have the potential to achieve. The acute focus on ESG seen across all sectors means that renewable energy and resources asset targets are in focus.

The mid-market landscape continues to be the most competitive, and possibly the most overcrowded, segment of the global private equity market in recent years. This is compounded by the need for many sponsors to access alternative credit solutions to complete leverage buyout transactions, which has added to the considerable pressure and focus on increasing investor returns. As a result, the fast pace and large number of participants involved in pre-emptive bid and conventional auction processes persist.

This chapter provides an overview of the key trends and features of private equity transactions in Jersey and those involving Jersey-registered vehicles (ie, an acquisition (or disposal) where the buyer (or seller) is a special purpose vehicle owned and controlled by a private equity fund).

1.2 Market Activity and Impact of Macro-Economic Factors

Domestic market activity in Jersey is dominated by private equity involvement in financial services sector businesses, such as professional corporate services and trust company businesses, which are the target of primary, secondary or tertiary private equity investment. Furthermore, 2024 has also seen reasonable levels of M&A trade sale locally. Certain standout transactions have triggered significant consolidation in the trust and corporate services industry. Global banking businesses with a Jersey footprint also provide non-core business carve-out opportunities for private equity sponsors in the local financial services sector.

Separately, sustained use of Jersey vehicles by leading private equity sponsors investing in larger-scale primary cross-border deals across 2023 saw a spread of activity across the following asset sub-classes:

- professional services, advisory and consultancy;
- wealth management-related financial services;
- enterprise software and business-to-business services; and
- renewable energy.

Rising interest rates, general equity market volatility and tightening credit market conditions (particularly in the leveraged loan space) have meant that private equity activity in the Jersey

market, and in cross-border transactions where Jersey vehicles are used, has increasingly been focused on legal, tax and financial due diligence, closer examination of target growth strategies and a realignment of expectations on valuation.

Higher costs of borrowing in the UK and European market have led mid-market, and some top, sponsors to access leverage via alternate credit providers. This has positively impacted the credit markets by enabling borrowers to fund acquisitions on more flexible terms, given that most alternate financiers are not constrained by the kind of regulatory capital and covenant criteria that constrain mainstream bank lenders.

It remains to be seen how global M&A markets may be affected by changes of government in the UK, other major European economies and the United States.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Anti-money Laundering (AML) Supervisory Regime

In mid-2023, the practical effect of the changes made to Jersey's AML supervisory regime (known as the Schedule 2 regime) was felt by local corporate service providers. Although significant to Jersey's own efforts and contribution to the global combatting of financial crime, M&A market participants transacting in Jersey or utilising Jersey acquisition vehicles for cross-border transactions will not have been impacted by the changes to the Schedule 2 regime. The main difference in the new regime is the shift in primary responsibility for AML regulatory compliance away from Jersey corporate service providers to Jersey vehicles directly involved in certain types of financial services activities, leading to their appointment of Jersey Financial Services Commission (JFSC)-regulated AML service providers.

Jersey Funds Regimes for Private Equity Funds

The Jersey Private Fund (JPF) regime, which was introduced by the JFSC in 2017 and last updated in July 2024, has become an increasingly popular regulatory regime for structuring private equity funds in Jersey. More than 700 JPFs had been established by March 2024, with the regime having particular application to funds with up to 50 investors.

The JPF regime is streamlined and flexible, with a 48-hour online authorisation procedure, and is subject to a light regulatory touch but without compromising investor protection. JPFs are aimed at professional investors, high net worth investors and investors committing at least GBP250,000 (or equivalent). For more widely marketed private equity funds, the Jersey Expert Fund regime also remains popular – it has no upper limit on the number of investors and a commitment level of at least USD100,000.

Recent enhancements include the following:

- co-investment arrangements that are part of a fund's carry/incentive scheme are now excluded from the investor count; and
- certain family and incentive arrangements are not treated as JPFs, and the definitions of employees and family connections have been further widened.

As private equity funds are typically closed-ended, the attraction of JPFs and expert funds in terms of speed of establishment, together with appropriate and proportionate regulation suited

to the sophisticated investor base, continues to position Jersey favourably for fund establishment by both existing and new sponsors, and the majority of new structures tend to be JPFs.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Private Equity Fund Regulation

The principal legislation governing the regulation of private equity funds in Jersey is the Collective Investment Funds (Jersey) Law 1988 and, for private funds, the Control of Borrowing (Jersey) Order 1958. Funds that are marketed in Europe are also subject to the Alternative Investment Funds (Jersey) Regulations 2012 (the "AIF Regulations"). Funds that are marketed in the EU are subject to the code of practice for alternative investment funds and AIF services business (the "AIF Code").

In addition, all funds are subject to the requirements of Jersey's AML regime, which applies AML rules to all financial services businesses in Jersey. Jersey-based service providers for funds are subject to regulation under the Financial Services (Jersey) Law 1998 (the "FS Law") unless an exemption applies. Providers of fund services must be registered and regulated by the JFSC, pursuant to the FS Law.

AML/KYC

Relevant sanctions and the usual AML/KYC rules apply to private equity transactions; there are no Jersey-specific restrictions. The alignment of Jersey's AML regulatory regime with current Financial Action Task Force standards and recommendations has not had any impact on private equity transactions in Jersey or the use of Jersey-registered acquisition vehicles.

National security regulation in Jersey is very similar to that in the UK. Financial investors are screened by local authorities in accordance with international standards. There is no particular focus on sovereign wealth fund (SWF) investors, although many SWFs are, in the ordinary course, subject to robust checks either as principal deal counterparties (including as co-investors) or as fund investors/limited partners.

Takeover Code

The Takeover Code applies to certain transactions involving Jersey companies. Takeover Code compliance is implemented by the UK Takeover Panel, as the designated authority under primary Jersey legislation.

A Jersey company is subject to the Takeover Code if any of its securities are listed on a regulated market or multilateral trading facility in the UK, or on any stock exchange in the Channel Islands or the Isle of Man. This includes being listed on the main board of the LSE and the Alternative Investment Market. A Jersey company that has shares listed on other exchanges, such as the NYSE and Nasdaq, may also be subject to the Takeover Code if the Panel considers that the company's management and control are in the UK, the Channel Islands or the Isle of Man.

Domestic competition and antitrust regulation applies where merging businesses meet relevant thresholds. Where applicable, the approval of the Jersey Competition Regulatory Authority may be required.

EU Foreign Subsidies Regulation (FSR)

The EU FSR does not directly apply in Jersey and so is not relevant to local M&A transactions therein. However, Jersey financial services businesses that form part of wider UK and European or global groups may be tangentially impacted.

One general observation regarding EU FSR is that, in addition to the usual M&A considerations (such as the completion timetable, closing conditions and risk allocation in deal documents), the EU FSR regime is likely to introduce additional and potentially significant disclosure requirements for private equity sponsors.

4. Due Diligence

4.1 General Information

The focus of due diligence in Jersey is on verifying corporate existence, maintaining solvency and other corporate governance-related matters. Typically, buy-side legal due diligence involves utilising publicly available information and any information made available by the seller as part of the tender/auction process. Where a target is prepared to support the offer, bidders may also present separate requests in respect of matters on which they require further information. Such legal due diligence is usually secondary to financial (including taxation) due diligence.

With a hostile bid, legal due diligence is generally limited to information in the public domain (see **4.2 Vendor Due Diligence**). However, a bidder may be able to obtain information from the target that has been provided to a competing bidder if the Takeover Code applies. This is because the target has a duty to provide equal information to rival bidders in a competitive situation.

Public information available to bidders in Jersey includes:

- audited accounts (for public companies only);
- memorandum and articles of association;
- details of directors and shareholders (for public companies only);
- prospectuses; and
- other information that may be available via UK sources, such as public announcements issued by the target.

4.2 Vendor Due Diligence

Vendor due diligence (VDD), as part of private equity transactions, depends almost entirely upon the shape of the target group structure and the target asset or business.

VDD is often not comprehensive and, in Jersey, it is not generally considered a substitute for a buyer's own due diligence. A VDD report may provide a helpful start to the due diligence process. An obvious advantage is where a vendor is prepared to make representations and warranties, or provide indemnities, in the transaction documents in relation to information contained in the VDD report. Typically, sell-side legal advisers present VDD reports as being based on a risk review mandated by the seller/target group, in contrast to a deeper-dive diligence exercise.

It is not common in Jersey for advisers to permit reliance on buy-side diligence reports in Jersey to financiers or warranty and indemnity (W&I) insurers. However, it is typical for buy-side advisers to liaise with both financiers and insurers on behalf of bidders, to address and provide comfort around specific legal issues that may arise as part of financing or the writing of a buyer's W&I policy.

5. Structure of Transactions

5.1 Structure of the Acquisition

Most private equity acquisitions in Jersey are structured as private treaty sales with purchase agreements negotiated between the parties. However, there has been an increase in the use of the Jersey statutory merger procedure

to effect both private and public acquisitions in recent years. Competitive auction processes are common in the infrastructure space, where prime assets are coveted.

Larger transactions involving a Jersey target company or listed targets may proceed by way of a court-sanctioned scheme of arrangement or a process governed by the Takeover Code. The Takeover Code, and the appointment of the Takeover Panel to administer provisions thereof, have been adopted in Jersey through the enactment of domestic legislation. Other acquisition types include statutory mergers and business asset transfers, although these are less frequently encountered.

5.2 Structure of the Buyer

Straight-line Jersey private company acquisition structures are preferred by private equity sponsors and co-investors.

Tiered Jersey debt and equity acquisition structures involving a topco (top holding company), midco (intermediate financing vehicle) and bidco (bid vehicle) are typical. Such structures have the following attributes:

- they enable structural subordination of intra-group/external financing;
- they facilitate the requirements of both private equity sponsor and target management;
- they provide UK-resident-non-UK-domiciled target management with remittance-based taxation options for future exit (eg, capital gains taxation);
- they allow for simplified dividend flows to private equity fund investment vehicles and ultimately limited partnership (LP) investors; and
- they should not be subject to onshore tax/stamp duty on future disposal.

In addition, the use of Jersey management incentive planning (MIP) vehicles for manager incentivisation aligns target management objectives with those of the private equity sponsor.

Recent years have seen a significant increase in the use of MIP vehicles for the many incentivisation-restructuring rounds that have occurred where portfolio company assets are in the buy-and-build phase.

5.3 Funding Structure of Private Equity Transactions

Generally, private equity transactions are financed via a mix of equity contributions sourced from investing private equity funds and external debt/leverage provided by syndicate banks, institutional financiers and a range of alternate credit providers. For larger transactions, accessing funding from the debt capital markets (ie, bridge to bond) is attractive from a cost of funds perspective. Unitranche financing, which involves a hybrid loan structure combining senior and subordinated debt into one loan facility at a blended interest rate, has also proved attractive to private equity sponsors.

Interest rate movement and the high margin cost of vanilla leveraged financing options has led the most active sponsors to seek out alternative and mezzanine-style credit solutions. This has impacted credit committee consideration of new money transactions, resulting in more protracted come-to-market periods. For alternate credit funding of private equity acquisition transactions, it is relatively common for private debt funds to have agreed to provide committed capital at signing. The efficiency associated with not having to syndicate or take out bilateral debt post-completion has driven this particular behaviour. Overall, the market has coped well in

the past 12 months, wherein leverage terms for private equity transactions have changed.

Both fund-level and leverage financing options feature significantly in downstream private equity transactions involving Jersey vehicles. Market conditions have enhanced the attractiveness for private equity sponsors of participating in leverage financing solutions as alternate credit providers. The prominence of subscription line, net asset value and hybrid fund financing facilities (used to finance short-term settlement disparities between general partner calls on investors for committed capital and the need for available capital at the bid or portfolio company acquisition stage) has only continued to grow in recent years.

At signing, an equity commitment letter is used to provide contractual certainty of funds for sponsor contributions. For higher-value transactions, it is common to see debt and security documents agreed by signing (but left unexecuted) and confirmations given by the buy-side in relation to this to provide comfort to sellers.

5.4 Multiple Investors

Both joint venture and syndicated consortium investor transactions are common in Jersey, particularly in infrastructure asset deals. While not entirely "commonplace", the steady rise in pre- or post-closing co-investments involving multiple private equity sponsors, or sponsors and their most valued limited partners, is starting to represent a greater proportion of all private equity deals.

Co-investment structures are an increasingly popular way to syndicate the sponsor equity contribution to be made. It is not uncommon to see primary investment opportunities initially involve private equity sponsors acquiring minority interests in target groups pending enterprise valuation adjustments and similar. Joint venture-style arrangements between private equity fund sponsors and corporate investors are increasing in frequency.

Towards the end of 2023, there was a definite uptick in North American sponsors involving corporate or sovereign co-investors in the early stages of a proposed transaction. It is understood that this assists with bidder profiling in granting exclusivity, or as part of participating in a competitive auction process.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

There is generally no restriction on the type of consideration that can be offered on a private treaty sale or negotiated offer. Consideration can therefore include, among other things, cash, loan notes and shares. In a Takeover Code-governed transaction, for a mandatory offer, the consideration must be cash, or be accompanied by a cash alternative, and it must comply with minimum consideration requirements.

The nature of the underlying asset, sponsor approach/appetite and certain transaction-specific requirements are all factors that contribute to the form of consideration structure used in Jersey private equity deals. No predominant form of consideration structure is used in these types of transactions: fixed-price, locked-box and completion accounts mechanisms are variously seen.

The protection afforded by private equity buyers and sellers in relation to the consideration mechanism is generally the same as the protec-

tion provided by corporate buyers/sellers. This includes earn-outs, deferred consideration, anti-embarrassment mechanisms and (less frequently) consideration collateral or security.

6.2 Locked-Box Consideration Structures

The use of locked-box consideration structures in Jersey private equity transactions is not predominant. The specific features and uniqueness of each separate transaction generally determine whether a completion accounts or locked-box consideration mechanism is employed. Levying interest charges on any value leakage that is not permitted leakage is not common or market standard in Jersey.

6.3 Dispute Resolution for Consideration Structures

In many private equity transactions, locked-box consideration structures do not have specific dispute resolution mechanisms. In deals where completion accounts are required, specific dispute resolution mechanisms are more common, where either party may refer a dispute for determination by an independent expert or auditor. General dispute resolution provisions under a share sale and purchase agreement often refer to arbitration proceedings, as agreed between the parties.

6.4 Conditionality in Acquisition Documentation

Conditionality is standard in private equity transactions and would include any necessary shareholder and regulatory (including competition or antitrust) approvals and other matters that are not within the bidder's control, or are dependent solely on the bidder's subjective judgement. Conditionality for financing and other kinds of third-party consents is less frequent.

Takeover Code-governed offers must include a condition that the offer will lapse if the bidder does not acquire (or contract to acquire) more than 50% of the voting share capital of the target. In Jersey, acquiring or contracting to acquire 90% of the target share capital to which the offer relates enables the bidder to engage in the compulsory acquisition procedure available under Jersey company law.

Material adverse change/effect (MAC) provisions are common and have been a focus during the COVID-19 pandemic. The acceptance of generic MAC provisions in the current climate is unlikely, but a MAC provision that addresses a specific risk or issue may be acceptable.

6.5 "Hell or High Water" Undertakings

It is not common for a private equity-backed buyer to agree to "hell or high water" provisions in transactions that are subject to regulatory approvals (including competition and antitrust). Agreements to absolute obligations of this kind, which may result in divestitures or require certain outcomes in the context of pending litigation, are more common in a public M&A context.

6.6 Break Fees

Deal-protection measures like break fees have not featured in Jersey transactions involving private equity-backed buyers. In larger cross-border transactions with a Jersey element, break fees were more common prior to their abolition as a result of changes to the Takeover Code in September 2011.

Reverse break fees are not customary in Jersey transactions involving private equity-backed buyers. However, as they are not prohibited by the Takeover Code, they are permissible subject to Jersey law rules on excessive penalties, which

are, broadly speaking, similar to those that apply under English common law.

6.7 Termination Rights in Acquisition Documentation

Deal execution and completion risk remains high on the agenda for private equity transaction participants, so parties (and private equity-backed buyers in particular) will typically only permit the termination of an acquisition agreement in Jersey in very specific (and narrow) circumstances. Termination rights are, in general, limited to mandatory conditions (outside of the control of each party) that are not satisfied by a certain long-stop or "sunset" date. A typical long-stop period may run to, for example, six months.

Otherwise, MAC provisions, as discussed in **6.4 Conditionality in Acquisition Documentation**, potentially allow a party to terminate or adjust its obligations in the event of a change in circumstances that significantly affects the value of the target. Automatic termination triggered by a contractual provision in an acquisition agreement is rare.

6.8 Allocation of Risk

In Jersey, market practice is a more powerful driver of the allocation of risk between parties to a private equity acquisition transaction than the type or nature of the parties involved. For example, numerous trust company and corporate services businesses in Jersey have been the subject of primary private equity investment, as well as secondary and tertiary management buy-outs (MBOs) and management buy-ins. In the majority of these deals, it is common for risk to be shared between the parties, although on balance, private equity sellers prioritise minimising their exposure to liability during the sale of a portfolio company.

The impact of this is that the extent to which private equity sellers assume ongoing liability in a divestment is very limited. On buyer-insured transactions, nominally capping seller liability will result in only theoretical risk for private equity sellers.

The main ways a private equity seller will look to limit liability include negotiating:

- caps on financial exposure;
- time periods by which claims can be made (eg, 12 to 24 months);
- de minimis claim levels (individual and aggregate);
- regulating the conduct of a dispute regarding a breach of warranty or any third-party claims; and
- obligations on buyers to mitigate any loss suffered.

6.9 Warranty and Indemnity Protection

Warranty coverage in private equity transactions in Jersey is generally limited to the title of target shares or assets, the capacity and authorisation to enter into the transaction, solvency, and the accuracy and completeness of the information provided to the buyer. Warranties are usually limited in duration to a 12- to 24-month claim period. While most primary private equity investment transactions in Jersey involve a management team standing behind the deal terms and providing certain limited warranties, other deal-protection measures, such as earn-outs and lock-ins, provide more comfort to private equity-backed buyers.

Full disclosure of the data room is typically allowed against the warranties. See **6.8 Allocation of Risk** regarding customary limitations on liability for warranties in Jersey.

6.10 Other Protections in Acquisition Documentation

Indemnities from a private equity seller and/or management team are not common in an MBO context. Earn-outs, lock-ins and price adjustment provisions are often negotiated as part of the management-specific terms of an acquisition agreement. A tax covenant and deed of indemnity is also a relatively common feature, further allowing the allocation of risk between buyer and seller. Dollar-for-dollar recovery for unexpected tax liabilities arising from pre-completion profits or events occurring prior to completion provides buyer protection.

Buyer (W&I)-insured deals are becoming increasingly common, following the trend in the UK and elsewhere. W&I coverage increases the relatively low level of protection that management teams are able to provide, and which private equity sellers are not prepared to consider. The additional diligence and input from a seller on an insured deal is often accepted as being necessary from a buyer's perspective. The cost of insuring known risks is generally prohibitive, so is less common. W&I cover typically seeks to reduce buy-side risk in relation to certain fundamental and business warranties, but not tax matters.

Escrows and retentions are rarely used in Jersey private equity transactions to back the obligations of private equity sellers. An exception may be a financial services business that is subject to regulatory examination given that, in 2019, the financial services regulator in Jersey levied its first civil penalty against a registered financial services business. This trend continued into 2022. Extension of the financial services regulator's enforcement powers (including the power to levy financial penalties) is the subject of a current industry consultation. Another form of exception to an escrow retention arrangement may be where there is a known risk or prospect of settling pending or threatened litigation against the target.

6.11 Commonly Litigated Provisions

Litigation is not common in connection with private equity transactions in Jersey or involving Jersey entities. The limited contractual liability of private equity sellers means that the appetite for transaction counterparties to look to litigate disputes is limited. Alternative dispute resolution pathways often mean that disputes in relation to earn-outs, consideration calculation and related matters are resolved at an early stage. Expert determination on completion account disputes is generally provided in acquisition agreements to be binding and conclusive.

7. Takeovers

7.1 Public-to-Private

Public-to-private transactions (also known as take-privates) are not common in Jersey from a domestic utility or infrastructure asset point of view. However, as many Jersey companies are listed on stock exchanges throughout the world, including the main board of the LSE and, increasingly, North American stock markets including the NYSE, Nasdaq and the Toronto Stock Exchange, a number of those listed companies have become targets in take-private transactions. The trend seen in 2022 and 2023 of take-privates gaining traction where there has been private equity interest in UK-listed businesses has continued into 2024.

The following kinds of transactions are common in a private equity acquisition context.

- A take-private or takeover offer involving a bidder who makes an offer to the listed tar-

get's shareholders to acquire their shares in the target. After the takeover is complete, the bidder and the target remain separate companies and the target becomes a subsidiary of the bidder. The bidder may compulsorily acquire the remaining shares if it acquires at least 90% of the shares to which the offer relates.
- An alternative form of public company acquisition transaction is a Jersey court-sanctioned scheme of arrangement. This is a statutory court process involving a compromise or arrangement between a company and its members. It results in the bidder holding all of the target's shares.
- Jersey also has a statutory merger regime, which may also be used in a takeover situation for cash or equity (and including cross-border mergers if the other relevant jurisdictions permit mergers).

In the absence of targeted institutional investor activism, the role of the target and its board of directors in public-to-private transactions is to facilitate transparent and meaningful negotiation to elicit shareholder value in line with the strategic objectives of the target business.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

If the Takeover Code applies prior to the announcement of a bid or a possible bid, all persons privy to confidential information concerning the bid or possible bid, particularly price-sensitive information, must treat that information as secret and may only pass it to another person if it is necessary to do so and if that person is made aware of the need for secrecy. All such persons must conduct themselves in such a manner as to minimise the chances of any leak of information (Rule 2.1 of the Takeover Code).

If the Takeover Code does not apply, Jersey law does not otherwise specify any secrecy or material shareholding disclosure obligations. However, it may be prudent to maintain secrecy for commercial and/or other reasons. In addition, the laws and regulations of other jurisdictions (for example, the rules of the stock exchange on which the target company is admitted to trading) might impose secrecy or disclosure obligations on the bidder and/or target company.

7.3 Mandatory Offer Thresholds

Where the Takeover Code applies, a mandatory offer to acquire the entire issued share capital of a target must be made when the bidder (or parties acting in concert) achieves one of the following (Rule 9 of the Takeover Code):

- acquires an interest resulting in the bidder holding a stake of 30% or more of target voting rights; or
- intends to acquire an interest in shares carrying between 30% and 50% of the target's voting rights, and the bidder (or concert parties) acquires an interest in any other voting shares in the target.

7.4 Consideration

Cash consideration is common in Jersey, but there are no restrictions on the form or type of consideration in a voluntary offer. Consideration can therefore include cash, loan notes and shares, among other things.

If the Takeover Code applies, the consideration for a mandatory offer must be in cash, or must be accompanied by a cash alternative and comply with the applicable minimum consideration requirements.

There are no other specific minimum price rules that apply to tender offers in relation to Jersey businesses.

7.5 Conditions in Takeovers

If the Takeover Code does not apply, Jersey law does not specify any particular obligations or duties in relation to conditions or pre-conditions. However, financing conditions are generally not accepted in private equity-backed takeover offers.

If the Takeover Code applies, a voluntary bid can be made subject to the satisfaction of pre-conditions. In such cases, the Panel must be consulted in advance about any proposal to include (in an announcement) any pre-condition to which the bid will be subject. As a general rule, the Panel will not consent to the inclusion of a pre-condition if it depends solely on subjective judgements by the directors of the bidder or the target.

Except with the consent of the Panel, a bid must not be announced subject to a pre-condition unless the pre-condition relates to a decision that there will be no reference to the competition authority or initiation of proceedings by the European Commission, or it involves another material official authorisation or regulatory clearance relating to the bid. No conditions are permitted in the case of a mandatory bid, except with the consent of the Panel (other than that the bidder obtains acceptances that give it more than 50% of the voting rights of the target company).

7.6 Acquiring Less Than 100%

Jersey company law gives private equity bidders the legal right to compulsorily acquire shares in a target that it does not seek or ultimately obtain as a part of its offer (known as a “squeeze-out right”). In a takeover offer, if the bidder has acquired or contracted to acquire 90% in nominal value of the shares to which the offer relates, they can acquire the remaining 10% by giving notice to the relevant shareholders.

No compulsory acquisition notice can be given unless a bidder has acquired or contracted to acquire 90% of the target’s shares within four months of an offer. The shareholder notice must be served within two months of the bidder acquiring or contracting to acquire the 90%. A copy of the notice must be sent to the target. Bidders are bound to acquire the remaining shares on the terms of the original offer.

Six weeks after the date of the notice, a bidder must pay the target for the remaining shares it wishes to compulsorily acquire. A share transfer form executed on behalf of the non-selling shareholder by the bidder must be sent to the company with payment; upon receipt, the company must register the bidder as shareholder. Inverted rights of non-selling (minority) shareholders also exist to require their shares to be acquired by a bidder who has acquired (or contracted to acquire) 90%. The Jersey court has general jurisdiction to hear relevant applications about compulsory acquisition matters.

There are no particular threshold acquisition levels or mechanisms that are typically required for a private equity-backed bidder to achieve a debt push-down into the target following a successful offer.

7.7 Irrevocable Commitments

In situations where an offer is recommended by the board of directors of the target, it is common for a private equity bidder to obtain irrevocable undertakings or commitments from the main shareholder(s). Irrevocable undertakings/ commitments and letters of intent are permit-

ted by the Takeover Code and must comply with the rules therein. Achieving a certain level of irrevocable commitments in the pre-bid stage is often key to the private equity bidders advancing offers. Irrevocable commitments customarily oblige a shareholder making such a commitment to accept the private equity bidder's offer by a certain time.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Unsurprisingly, the incentivisation of management teams is a key feature of private equity transactions in Jersey and those that involve Jersey-registered vehicles. Different drivers and expectations from both the private equity sponsors and the management team come into focus where the market is moving to a more "patient capital" model, compared to shorter hold periods typically associated with private equity (ie, in the seller-friendly landscape of the last five or six years). Up to 10% of equity participation by management is common, but certain more entrepreneurial management teams have been able to command a higher proportionate equity ownership share. On primary investment transactions, founders generally retain more substantial equity ownership interests.

8.2 Management Participation

There are a number of different ways of structuring management participation in private equity transactions in Jersey. It is common for managers to subscribe for sweet equity on primary investments and for part of the institutional strip on secondary buyouts where managers roll over on the same terms (and equity to debt ratio) as the private equity sponsor.

Preference shares (disenfranchised as to voting/any blocking trigger) are also used in the following arrangements where incentivisation is planned for a larger number of managers/executives:

- long-term incentive plans;
- share options plans;
- management incentive plans;
- deferred share plans; and
- joint ownership equity plans.

8.3 Vesting/Leaver Provisions

If managers leave the portfolio business before a certain date, they will normally forfeit their sweet equity. Good and bad leaver provisions are typical, with preferential terms applying to individuals who leave for "good" reasons. Generally, this includes managers who leave due to illness, death, disability or retirement. Vesting provisions are typical for management equity in Jersey. Four or five years is the usual vesting period; otherwise, vesting on an exit event is most common. Full vesting on an exit event that takes place earlier than anticipated generally means that everyone benefits.

Alignment of management and private equity sponsors on exit timing is critical. Where sponsors seek to exit early, there is often little value in management's sweet equity, which can damage an otherwise good relationship. Management increasingly look to secure certainty regarding exit timing. Where an exit takes place outside of this timeframe, one option is that management are compensated for the lost "opportunity"; however, this approach is not favoured by sponsors.

8.4 Restrictions on Manager Shareholders

Customary restrictive covenants agreed to by management in private equity transactions in Jersey include non-compete, non-solicitation and non-disparagement. Such covenants are normally part of the portfolio company group employment contract arrangements for executives and senior management; however, they are unenforceable unless they are reasonable as between the parties and in respect of the public interest.

In practical terms, enforcement of these types of covenants is not straightforward. Where former manager shareholders with specific knowledge of the operations of a Jersey target business are free of restrictive covenants, it is not uncommon to see prospective bidders in secondary and tertiary transactions engaged by the appointed financial advisory team to provide specialist consultancy input on the process.

8.5 Minority Protection for Manager Shareholders

Management shareholders in private equity transactions are not afforded greater or different rights than minority shareholders in other situations under Jersey company law. The standard legal protections that exist include claims in relation to minority oppression and unfair prejudice, etc.

It is usual for contractual pre-emption rights in favour of management to exist in relation to sweet equity. Such rights are intended to offer some kind of anti-dilution protection to management. However, if significant additional equity funding is obtained, or if a larger number of new or existing management teams are offered and take up sweet equity, limited pre-emption may not fully or effectively operate as anti-dilution protection. Limited rights of veto may exist in relation to a narrow range of matters specifically concerning the portfolio business.

Management would not typically have any right to control or influence the time, form and mode of exit that a private equity sponsor may wish to adopt in relation to a portfolio asset.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

Where private equity sponsors hold a majority ownership position in a portfolio company asset, they normally enjoy significant veto rights over major corporate, commercial and financial matters pertaining to the portfolio company business, although thresholds are commonly set to ensure that day-to-day decisions can be taken by management. In other words, management will have operational control of the business, whereas private equity sponsors will have oversight and ultimate influence over management by being able to control the board of the holding company of the portfolio business.

Management business operation and private equity sponsor control rights are regulated in a shareholders' agreement that governs their relations as shareholders in the portfolio company. This will likely include the following provisions, among others:

- covenants from management with regard to the conduct of the business of the portfolio company;
- extensive veto rights for the private equity sponsor;
- restrictions on the transfer of securities in the portfolio company; and

- provisions regarding further issuances of shareholder equity/debt.

In addition, the constitutional documents may include governance arrangements, particularly with regard to the transfer of shares. The extensive veto rights in favour of private equity sponsors will typically be split between director veto rights and shareholder veto rights. Such veto rights (or reserved matters) would include amendments to the capital structure or constitutional documents; entering into, amending or terminating material contracts; changing the nature of the business or entering into new business lines; and commencing or settling litigation.

In a minority private equity investment, given that the private equity sponsor is unlikely to have board control, it is usually much more focused on veto controls to the extent that, in certain cases, a minority investment may result in more veto control than might be the case in a majority investment.

Statutory (shareholder) information rights in relation to private companies in Jersey are limited.

9.2 Shareholder Liability

Jersey company law contains the concepts of separate legal personality and limited liability. It recognises that the legal personality of a company is separate to that of its shareholders and that, fundamentally, a shareholder's liability is limited to the amount invested in a company.

A corollary of this is that, in exceptional circumstances, a Jersey court might be prepared to "lift the corporate veil", which may result in a private equity sponsor being liable for the actions of its portfolio company. To pierce or lift the veil, there needs to be a deliberate evasion of an existing legal obligation or liability by the shareholder concerned. The remedy of piercing the corporate veil, so as to impute liability to a private equity sponsor (majority portfolio company shareholder), is unlikely to be capable of being successfully engaged as a matter of Jersey law based on customary private equity transaction structuring, as discussed in **5.1 Structure of the Acquisition**.

The same concept of limited liability applies to limited partners of Jersey LPs, where limited partners will generally only be liable for debts of the partnership if they have participated in the management of the partnership (excluding a number of specific safe harbour activities), thereby jeopardising the limited liability inherent in such structures.

10. Exits

10.1 Types of Exit

Portfolio asset-holding periods stretch from five to eight years, depending on the nature of the asset and other prevailing market conditions. Also, the seller-friendly nature of the market in Jersey over the last five or so years has meant that competitive auction processes (including with pre-emptive offers) have become very common.

As most private equity transactions in Jersey are of financial services sector/regulated businesses, auction sales to strategic trade buyers and other private equity sponsors (in secondary or tertiary transactions) are all normal. Since 2021, given the COVID-19-induced volatility in capital markets and in relation to FX currency trading, an IPO has been the least attractive form of exit strategy. Dual-track processes (IPO and private sale) running concurrently have become more common in Jersey in the last four to six years.

However, it is interesting to note that, during this time, only three Jersey private equity-owned portfolio companies have conducted successful IPOs, implying that a higher rate of success has been achieved with private sale processes. Reinvestment by private equity sponsors (save for an IPO exit scenario) is not typical. It is expected that a number of Jersey listed businesses that have been exited via an IPO will be the subject of take-private acquisition activity in the next 12 to 18 months.

Trade sale exits are also becoming more common and demonstrative of the level of consolidation that has occurred in the financial and corporate services sectors in the Jersey M&A market.

10.2 Drag and Tag Rights

Drag-along rights (ie, the right of a private equity sponsor to force other shareholders, including management, to sell their shares in a portfolio company) are usual in the equity capital structuring arrangements for private equity-sponsored transactions. There are no typical drag-along or tag-along thresholds in Jersey. It is rare for drag-along rights to be exercised; however, where there is a large number of non-institutional sellers (eg, management shareholders), a drag provision might be relied upon for administrative convenience and to avoid the need to convene a large number of parties to a sale and purchase agreement.

10.3 IPO

The appetite for IPO exits by private equity sponsors will be dictated by equity capital market conditions, and it is envisaged that COVID-19-induced volatility will reduce the attractiveness of an IPO exit from a portfolio company asset in the medium term.

In a successful IPO exit, a private equity sponsor (as selling shareholder) will be “locked up” for up to six months, with management locked up for a somewhat longer time (eg, 12 months). Relationship agreements covering lock-up and other management and transitional matters are generally entered into between the private equity sponsor seller and the listed company.

KENYA

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Cliffe Dekker Hofmeyr (incorporating Kieti Law LLP) is a leading Kenyan law firm that provides quality, specialised and personalised legal services in key specialist areas of practice. The firm's lawyers are recognised for their depth of expertise and extensive experience in all prominent sectors attractive to private equity investors in Africa. The firm's services include fund formation, portfolio acquisitions and exits, legal and tax due diligence, follow-on acquisitions, debt and equity restructuring or refinancing and business restructuring processes. The firm handles a wide range of cross-border transactions spanning Eastern Africa and other countries such as Mauritius, Nigeria, Ghana, the UK, and Norway, among others.

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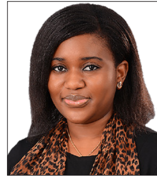

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

According to the East Africa Financial Review by I&M Burbidge Capital, published in July 2023 ("2023 IMB Review"), there were 93 private equity (PE) transactions in 2023, representing a 9.7% decline from the 103 transactions in 2022. The total disclosed value was approximately USD1.6 billion, marking a 3.5% decrease from the previous year. The average PE deal value increased by 19% to about USD25 million, while the median deal value rose by 32% to USD9.9 million.

Venture capital (VC) was the most active investment type in 2023, with 42 transactions, though this was a 36% decrease from the 66 transactions in 2022. The total deal value for VC transactions was around USD170.1 million, a significant 76% drop from 2022. The median deal value for VC transactions also fell by 36% to USD3.2 million.

The I&M Burbidge Monthly Financial Review for June 2024 ("2024 IMB Review") indicates that deal-making in East Africa showed resilience in the first half of 2024, with a total of 68 recorded deals, slightly lower than the 75 deals during the same period in 2023 and 72 deals in 2022. Disclosed deal values continued to decline, dropping 71.6% from a peak of approximately USD3.6 billion in 2023. Private equity activity saw the largest decline, with a 25% decrease to 12 deals compared to the first half of 2023. However, VC activity increased marginally by 3.8% compared to the same period in 2023.

According to the Africa Venture Capital Association report published in March 2023 ("AVCA Report"), Kenya ranked third in deal volume across Africa in 2023. Investments, totalling up to USD128 million, were directed towards start-ups in electrified transportation, recycling, sanitation, solar power, and waste management services. These investments and innovations reflect a broader shift towards circular economies in Africa, where waste is minimised, and materials are reused to promote sustainability.

Trends in M&A Deals

The 2023 IMB Review reports that mergers and acquisitions (M&A) activity saw a significant increase in 2023, with 27 transactions, marking a 29% rise from 2022. The total disclosed deal value reached approximately USD289.4 million, a substantial 139% increase from the previous year. African buyers were the main drivers of M&A, accounting for 59% of all deals, while global buyer interest also grew to 41%, up from 24% in 2022. Key sectors for M&A transactions included financial services, healthcare, agribusiness, ICT, and logistics. Kenya led with 21 deals, followed by Tanzania and Uganda with two deals each, and Ethiopia and Rwanda with one deal each.

According to the June 2024 IMB Review, M&A deals experienced significant growth during this period, with a total of 15 deals – an increase of 36.4% compared to the same period in 2023, despite most investor classes either experiencing a decline or remaining stable.

1.2 Market Activity and Impact of Macro-Economic Factors

Active Sectors

In the first half of 2024, the agribusiness sector was the most active, recording 15 transactions worth approximately USD238 million. The energy sector followed with ten transactions totalling around USD156 million, while the manufacturing sector completed the top three with nine transactions valued at about USD229 million. Accord-

ing to the June 2024 IMB Review, other sectoral deals for the half-year were as follows:

- financial services: eight deals;
- ICT and telecom: six deals;
- automotive: six deals;
- real estate: three deals;
- healthcare: three deals;
- logistics: two deals; and
- education: one deal.

Impact of Rising Interest Rates and Other Current Macro-Economic Factors Including Geopolitical Events On Private Equity Deal Activity

The macroeconomic situation in Kenya during the first half of 2024 may affect investor confidence and the performance of portfolio companies. In June 2024, significant civil unrest arose in Kenya due to the proposed Finance Bill 2024, which sought to significantly increase living costs. This unrest led President William Ruto to withdraw the Finance Bill on 26 June 2024. Furthermore, on 31 July 2024, the Court of Appeal of Kenya declared the entire Finance Act, 2023, unconstitutional, citing insufficient public participation in certain provisions before the law was enacted. These developments could disrupt Kenya's budgetary process, creating uncertainty in the market, particularly concerning provisions affecting private equity funds, such as the requirement to notify the Kenya Revenue Authority (KRA) about the sale of at least 20% of shares in a Kenyan company.

As a result, the KRA may intensify its tax collection efforts to meet the national budget of KES3.68 trillion. This is exemplified by a recent Tax Appeal Tribunal ruling in ECP Kenya Limited v Commissioner of Domestic Taxes (Tax Appeal No 335 of 2022), where it was determined that ECP Fund, a Mauritius-based private equity fund, was liable for Kenyan corporate income tax on gains from the sale of its stake in Java House Mauritius Limited due to the establishment of a permanent presence. Additionally, Kenya has been experiencing a wave of challenges among start-ups, with companies like Sendy, iProcure, Copia, and Gro Intelligence either going into administration, laying off staff, or shutting down entirely. This wave of start-up closures underscores the tough realities of Kenya's macroeconomic situation, particularly regarding fundraising and navigating the Kenyan market.

Despite these challenges, one positive outcome of the civil unrest in Kenya is that it could lead to greater government accountability, ensuring that budgetary processes and resource utilisation are more appropriate, ultimately fostering economic growth. Moreover, the June 2024 IMB Review remains optimistic about growth prospects in the short and medium term. The macroeconomic outlook for the region appears favourable, supported by a more stable global monetary environment, which is already reflected in the increased stability of many regional currencies compared to the previous year. Additionally, assistance from multilateral lenders is expected to bolster investor confidence, enabling them to leverage the region's key long-term growth drivers, such as demographics, energy sustainability, natural resources, and economic integration.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Legal and Regulatory Developments

Dual merger control

The legal landscape in Kenya continually evolves to adapt to market demands and commercial advancements. One significant development in

recent times has been the amendment of merger control laws to eliminate the requirement for dual approval from both the Kenyan and regional competition regulators.

Previously, acquisitions meeting both Kenyan and Common Market for East and Southern Africa (COMESA) merger notification thresholds necessitated the approval of both the Competition Authority of Kenya (CAK) and the COMESA Competition Commission (CCC). However, since 2019, merging parties are now only obligated to seek approval from the CCC if at least two-thirds of the turnover or assets of the merging parties are situated outside Kenya and then notify the CAK within 14 days. This development has simplified the approval requirements needed to complete a transaction, making transactions in the jurisdiction more attractive for private equity funds.

East Africa Community Competition Authority

The East African Community Competition Act of 2006 governs the supervision of merger activities within the East African Community (EAC) Member States (ie, Kenya, Uganda, Tanzania, Rwanda, Burundi, South Sudan and Democratic Republic of Congo). It mandates that any merger or acquisition that has a cross-border effect in the East African Community be notified to the East African Community Competition Authority (EACCA).

Presently, notifications for merger transactions within the EAC are not required, as the EACCA is yet to be operationalised. Despite this, in 2022 the EACCA entered into a bilateral agreement with the CAK to foster harmony in the execution of their respective mandates and to lay a framework for adopting a single merger notification regime in Kenya in respect of the EAC. It remains to be seen whether the EACCA will enter into similar arrangements with other EAC Member States or with the CCC. It is therefore important for private equity funds to take note of the developments of the EACCA so as to ensure that all the regulatory approvals with the jurisdiction are obtained.

Proposed removal of local shareholding for ICT companies

A local 30% shareholding requirement for Kenya companies providing information, communication and technology (ICT) services, is set to be removed off the back of international pressure to make Kenya a more attractive hub for international investors. The proposed amendment, announced by President Ruto in April of this year, is currently undergoing public consultation before it is tabled in front of Parliament. The removal of this shareholding requirement could increase investment in the ICT sector as it may allow 100% foreign ownership of ICT companies, operating in Kenya.

Regulation of private equity

The Capital Markets Authority (CMA) currently regulates venture capital companies incorporated in Kenya under the Capital Markets (Registered Venture Capital Companies) Regulations, 2007. The Kenyan government has taken steps to expand this regulatory oversight to venture capital organisations operating in Kenya. In this regard, the Capital Markets Act was amended in 2020 to enable the CMA to license, approve, and regulate private equity funds with access to "public funds". The term "public funds" remains undefined in the Capital Markets Act. The aim of the amendment is to safeguard funds accessed by private entities from public entities in Kenya, such as public pension schemes. In Kenya, pension schemes can invest up to 10% of their assets under management in private equity or venture capital investments.

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There have been no guidelines or regulations issued on how the proposed regulation of private equity funds that access "public funds" in Kenya will be effected or if the regulation will apply to offshore funds. We do not expect that this change will affect a majority of private equity funds with investments in Kenya, as the majority of these funds raise their capital offshore. It is, however, prudent to keep an eye on the developments for regulatory purposes.

Evolution of Kenyan tax regime

Several amendments to the Finance Act, No 4 of 2023 ("Finance Act") have resulted in the following amendments, which affect local private equity investments.

Capital gains tax

The rate of capital gains tax (CGT) on any gains obtained by a shareholder through an indirect sale of shares in a Kenyan company has been increased to 15%. This rule is relevant when the shareholder owned either a direct or indirect stake of at least 20% in the target company's shares at any point within the year prior to the sale. This amendment impacts private equity funds looking to exit an investment in a Kenyan target company.

Notification requirement

Transactions involving the sale of at least 20% of the shares in a Kenyan target company must now be notified to the Commissioner-General of the Kenya Revenue Authority ("Commissioner"). This notification introduces additional obligations on private equity buyers and sellers, and it is expected that the notification will alert the Kenya Revenue Authority of capital gains tax due following a 20% change of ownership.

Employee share ownership plans

The mechanism for computing the market value of shares under an employee share ownership plan (ESOP) will now be based on the price that the shares might reasonably be expected to fetch on a sale in the open market when the option is exercised. Previously, the market value was determined based on the amount agreed with the Commissioner before the grant of the options. This should be a point to note for private equity funds when setting up an ESOP in a target company or when undertaking a due diligence exercise of an ESOP.

Exemptions from income tax on royalties and interest

In the health sector in Kenya, the Finance Act now provides exemptions from income tax on royalties and interest paid by companies involved in the manufacture of human vaccines and lowers corporation tax for such companies to 10% from the standard rate of 30%. Reducing the tax burden in this manner will make these companies highly attractive for private equity funds, encouraging increased investment and fostering growth in the Kenyan health manufacturing sector.

Zero-rating of VAT

The zero-rating of VAT on the supply of electric vehicles in Kenya seeks to encourage the adoption of such vehicles in Kenya and this could result in increased investment in the sector.

Implementation of African Continental Free Trade Area (AfCFTA) Agreement

The AfCFTA agreement came into force in 2019 and created the world's largest trade area (by the number of participating states) with a population of about 1.3 billion people and a combined GDP of USD3.4 trillion. The main objectives of the AfCFTA are to create a single market for the

trade of goods and services on the continent, facilitated by the free movement of businesspersons and investments and significantly increase economic growth and development on the continent through an integrated single market for goods and services.

The AfCFTA has the potential to positively impact private equity investment in several ways, as outlined below.

Increased market access

The AfCFTA creates a larger and more integrated market, reducing trade barriers and making it easier for businesses to access new markets across African countries. This expanded market can attract private equity investors who seek opportunities in sectors benefiting from increased intra-African trade.

Diversification of investment opportunities

The agreement can lead to greater diversification of industries and sectors within African economies. Private equity investors can tap into a broader range of investment opportunities, including manufacturing, infrastructure, agriculture, services, and technology, as countries focus on economic diversification.

Requirement to disclose the beneficial ownership details with the registrar of companies

In addition, the Companies (Beneficial Ownership Information) Regulations, 2020 ("BO Regulations") introduced a requirement for companies incorporated in Kenya to file a register of beneficial owners holding. A beneficial owner is a natural person who holds at least 10% of the shares, voting rights, or a right to directly or indirectly appoint or remove directors of a company or exercise significant influence or control over the company. Private equity funds may therefore be required to disclose limited partners with controlling beneficial ownership as set out in the BO Regulations. In August 2023, the Business Registration Service (BRS) put out a notice of its intention to propose amendments to the Companies Act, 2015 ("Companies Act") to impose penalties on companies that have failed to declare beneficial ownership. Further, the BRS will also propose amendments prohibiting access to governmental services. Private equity funds need to be aware of this requirement and the imposition of penalties when deciding to invest in a Kenyan target company.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Key Regulators and Regulatory Issues Relevant to Private Equity Funds and Transactions

Merger control

As highlighted in **2.1 Impact of Legal Developments on Funds and Transactions**, the CAK is responsible for ensuring merger control and anti-trust compliance. In this regard, the CAK analyses and approves transactions with respect to the prescribed thresholds involving an acquisition of shares, business or other assets, whether inside or outside Kenya, resulting in the change of control of a business, part of a business or an asset of a business in Kenya.

The CAK has set specific thresholds for merger transactions that are (i) transactions always subject to notification, (ii) transactions potentially excluded from notification, and (iii) transactions excluded from notification.

Transactions always subject to notification

- A minimum combined turnover or assets (whichever is higher) in Kenya of KES1 billion and the turnover or assets (whichever is higher) of the target firm is above KES500 million.
- The turnover or assets (whichever is higher) of the acquiring firm is above KES10 billion and the merging parties are in the same market or can be vertically integrated, unless the transaction meets the CCC merger notification thresholds.
- In the carbon-based mineral sector, if the value of the reserves, the rights and the associated assets to be held as a result of the merger exceeds KES10 billion; or
- Where the firms operate in the COMESA, the combined turnover or assets (whichever is higher) does not exceed KES500 million and two-thirds or more of their turnover or assets (whichever is higher) is generated or located in Kenya.

Transactions potentially excluded from notification

- Where the combined turnover or assets (whichever is higher) is between KES500 million and KES1 billion.
- If, irrespective of asset value, the firms are engaged in prospecting in the carbon-based mineral sector.

Transactions excluded from notification

- The combined turnover or assets (whichever is higher) does not exceed KES500,000,000.
- The merger meets the COMESA merger notification thresholds and at least two-thirds of the turnover or assets (whichever is higher) is generated or located outside of Kenya.
- The merger takes place wholly or entirely outside of Kenya and has no local nexus.
- The merger involves a holding company and its subsidiary wholly owned by undertakings belonging to the same group or amalgamations involving subsidiaries wholly owned by undertakings belonging to the same group.

Transactions that have regional impact may also need approval from various regional authorities. If a transaction involves a party that operates in multiple member states of COMESA, and the merging company's turnover/asset value meets the following thresholds, the transaction may require approval from the CCC:

- The combined annual turnover or value of assets (whichever is higher) in the common market of all parties to a merger equals or exceeds USD50million; and
- The annual turnover or value of assets (whichever is higher) in the common market of each of at least two of the parties to a merger equals or exceeds USD10 million unless each of the parties to a merger achieves at least two-thirds of its aggregate turnover or assets in the common market within one and the same member state.

However, transactions that qualify for notification to the CAK and CCC need not be notified to the CAK if two-thirds of the turnover or assets (whichever is higher) is generated or located outside of Kenya. In this instance, the parties are required to file the merger notification with the CCC and only inform the CAK of the filing at the CCC within 14 days.

EU FSR Regime

The EU Foreign Subsidies Regulation (FSR) grants the European Commission the authority to investigate financial contributions provided by non-EU governments to companies operating within the EU. This includes (i) financial contribu-

tions from non-EU governments to companies with significant activities in the EU, and (ii) bids in public procurement processes by non-EU governments that meet certain thresholds. These regulations are unlikely to impact transactions in Kenya, and Kenya does not have comparable regulations in place.

Capital markets

As stated in **2.1 Impact of Legal Developments on Funds and Transactions**, the CMA has the power to licence, approve and regulate private equity funds that have access to public funds. In addition, the CMA oversees the capital markets sector in Kenya and its approval is required for the acquisition of companies listed on the Nairobi Securities Exchange (NSE) or entities licensed by it, such as investment banks, stockbrokers, securities exchanges, fund managers, dealers and depositories.

The CMA also regulates venture capital companies incorporated in Kenya and which provide substantial risk capital to small- and medium-sized businesses in Kenya through the Capital Markets (Registered Venture Capital Companies) Regulations, 2007 ("VC Regulations"). Fund managers of venture capital companies registered under the VC Regulations need to be approved by the CMA. The VC Regulations do not apply to venture capital companies or private equity funds registered outside Kenya.

Other regulators

In addition, PE transactions will be subject to additional regulations from other laws specific to different sectors, especially if these laws have provisions regarding ownership and control changes. For example, the purchase of a bank will need approval from the Central Bank of Kenya (CBK), while buying significant rights in an aviation company will require clearance from the Kenya Civil Aviation Authority.

Similarly, transactions in the communication, insurance, and energy sectors would require the approval of the Communications Authority of Kenya (CA), the Insurance Regulatory Authority (IRA) and the Energy and Petroleum Regulatory Authority (EPRA) respectively. It is useful to note that the approvals from the regulators are not exclusive of each other and that acquirers may be required to obtain multiple approvals for a transaction.

With regards to any recent developments or evolution of these regimes in our jurisdiction, see **2.1 Impact of Legal Developments on Funds and Transactions**.

Foreign investment restrictions

Restrictions on foreign investment tend to be sector-specific, as outlined below.

ICT Industry

As indicated in **2.1 Impact of Legal Developments on Funds and Transactions**, the restriction in the ICT industry with respect to 30% ownership was proposed to be scrapped by the Ministry of Information, Communications and the Digital Economy. In May 2023, the Cabinet approved a resolution to scrap the 30% local ownership requirement for ICT companies. The proposed amendment is currently undergoing public consultation, before it can be tabled by Parliament for approval. Should the amendment be approved, it will effectively remove all restrictions on foreign investment within the ICT industry.

Banking

In the banking industry, no individual or entity other than licensed financial institutions, the

government, foreign governments, state corporations, foreign companies licensed as financial institutions in their respective countries, or non-operating holding companies approved by the CBK, may hold more than 25% of the share capital of a Kenyan bank.

Insurance
In the insurance industry, at least 33.33% of the controlling interest in an insurer must be owned by citizens of a partner state of the EAC, a partnership whose partners are all citizens of an EAC partner state, or a corporation whose shares are wholly owned by citizens of an EAC partner state.

Aviation
In the aviation industry, companies licensed to provide air services must have at least 51% of the voting rights ultimately held by Kenyan citizens, the Government of Kenya or both.

Pensions
In the pensions industry, at least 60% of the paid-up capital of a pension scheme administrator must be owned by Kenyan citizens, unless the administrator is a bank or insurance company registered in Kenya.

Fintech
In the fintech industry, there are no specific restrictions on foreign investment yet. However, the government has been considering local shareholding restrictions in order to promote local participation in the financial services sector, while also attracting foreign investment. The restrictions on foreign investment are designed to strike a balance between these two goals.

National security review
There is no specific rule requiring security reviews for private equity transactions or investments by sovereign wealth investors. However, it was recently reported that the National Security Council sought involvement in the approval process for the sale of a 60% stake in a national telecommunications firm to the National Treasury by a private equity investor. This involvement was based on the fact that the telecommunications firm provides critical services to various government departments. It is anticipated that if a transaction involves matters of national security or significant public interest, the National Security Council will likely seek to be involved.

Listed company transactions
In the event that a private equity fund wishes to acquire a stake in a public company listed on the Nairobi Securities Exchange, the acquisition may be subject to the Capital Markets (Takeovers and Mergers) Regulations, 2002 (“Takeover Regulations”).

The Takeover Regulations prescribe that the following scenarios may require mandatory reporting to the CMA, for which the acquirer is then required to submit a takeover document as prescribed:

- the direct or indirect acquisition of the effective control of the voting rights of a listed company (ie, control of 25% of shares or voting rights);
- the direct or indirect acquisition of a company that has effective control of a listed company;
- the acquisition of more than 5% of the voting rights by an existing shareholder if the shareholder holds more than 25% of the shares but less than 50% of the voting rights;
- the acquisition of voting rights by an existing shareholder holding at least 50% of the voting shares; or
- the acquisition of at least 25% of a subsidiary that has contributed at least 50% of the

overall turnover of the listed company in the previous three fiscal years.

Importantly, changes to the Takeover Regulations have been proposed in the 2023 draft Capital Markets (Takeovers and Mergers) Regulations 2023 ("Draft Regulations") as part of an overhaul of capital markets regulation in Kenya. Key proposed changes in the Draft Regulations include:

- an increase in the threshold for determining effective control from 25% to 30%; and
- an exemption for squeeze-out transactions (ie, holder of 90% of issued shares of a listed company acquiring the remaining 10%) from its application; under the Takeover Regulations, if an acquirer purchases 90% of a company's voting shares, they must make an offer to the remaining shareholders to buy their shares at a price higher than the current market value.

The Draft Regulations provide for exemptions for complying with the subsequent takeover requirements in the following instances subject to any conditions that may be imposed by the CAK:

- an acquisition for the purpose of a strategic investment in a listed company that is tied up with management or any other technical support relevant to the business of such company;
- a management buy-out involving a majority of the employees of the offeree;
- a restructuring of the listed company's share capital including acquisition, amalgamation, compromises, arrangements, reconstructions and any other scheme approved by the CAK;
- an acquisition of a listed company in financial distress;
- an acquisition of effective control arising out of the disposal of pledged securities;
- an indirect acquisition where there is no transfer of shares in the listed entity and no impact on the listed company's operations, governance, assets, market capitalisation, sales or earnings;
- the maintenance of domestic shareholding for strategic reason(s); or
- any other circumstances which in the opinion of the Authority serve the public interest.

The Draft Regulations are yet to be placed before Parliament for its discussion.

Anti-bribery and sanctions

There has been no significant change in law or practice in the approach to anti-bribery and sanctions in the past 12 months.

ESG compliance

There have been no significant changes in ESG compliance in the past 12 months. However, ESG considerations remain an integral part of private equity transactions as discussed in **4.1 General Information**.

4. Due Diligence

4.1 General Information

Red-flag or selective legal due diligence is the increasingly common form of due diligence undertaken in Kenya. However, it is not uncommon for private equity funds undertaking their first investment in the Kenyan market to undertake full due diligence. The nature of due diligence is usually tailored to meet the private equity fund's interest and risk appetite and the target's business.

Legal due diligence exercises usually cover corporate structure and related issues, material contracts, competition, financial arrangements and indebtedness, employment, litigation, intellectual property, information technology, data protection, real estate, material assets, environmental, licences, insurance and tax.

ESG compliance is now a consideration in the legal due diligence exercise and often includes a review of a target's compliance with business ethics, corporate governance, bribery and corruption laws, compliance with human rights legislation and international treaties, respect for occupational health and safety, supply chain and waste management laws and inspection of environmental practices against environmental licenses, permits and legislation.

4.2 Vendor Due Diligence

Vendor due diligence tends to be used in large private equity transactions or auctions in Kenya and allow private equity firms to address the potential risk areas in the target and prepare for queries that a potential buyer might have. Typically, vendor due diligence tends to be red-flag or selective due diligence.

In addition, it is not unusual for sell-side advisers to rely on vendor due diligence reports by way of reliance letters provided to the relevant sell-side adviser.

5. Structure of Transactions

5.1 Structure of the Acquisition

Private equity acquisitions in Kenya are typically effected by way of a private treaty sale and purchase agreement of shares. It is not uncommon for acquisitions to be undertaken by way of asset purchases or by way of share subscription.

The terms of acquisition do not differ materially between privately negotiated transactions and auction sales.

5.2 Structure of the Buyer

In terms of deal structure, it is common in Africa and therefore in Kenya for private equity investments to be made into offshore holding companies of targets with subsidiaries in Kenya, rather than directly into operating entities in Kenya. Offshore holding companies are usually situated in countries that offer greater tax efficiency to the fund on exit, typically Mauritius or Delaware. Mauritius's placement (and subsequent removal) on the "Grey List" has also opened the door for new offshore jurisdictions such as Rwanda with its financial centre, offering tax incentives for investors. The set-up offshore holding companies mostly invest directly in the target company and are directly involved in the negotiation of the documentation.

5.3 Funding Structure of Private Equity Transactions

Private equity deals are typically financed through either equity or debt or a combination of both.

Although Africa-focused private equity funds are currently encountering fundraising difficulties, the practice of securing committed debt funds at the signing stage of deals is less prevalent in Kenya compared to more developed financial markets. Private equity firms in Kenya typically do not rely on financing from third-party lenders like banks and financial institutions. Instead, they may choose to raise funds from existing shareholders or investors to spread risk and ensure returns at the point of exit. Additionally, the use of equity or debt commitment letters in Kenya-based private equity transactions is uncommon. When such letters are used, they

are often not disclosed publicly and may include stringent conditions that are challenging to meet given the prevailing macroeconomic conditions.

5.4 Multiple Investors

Deals involving a consortium of private equity sponsors are not uncommon in Kenya. We have seen private equity firms invest in consortiums in a bid to spread the risk of large transactions and to ensure a return on investment at the point of exit. In 2021, it was reported that a consortium of investors led by a major South African private equity fund manager had invested in a major mobile network in South Africa. This has been the recent trend with private equity firms looking to spread risk.

Co-investment by other investors alongside the lead private equity fund are also relatively common. Co-investors may include limited partners (LPs) of the fund who opt to invest directly in specific deals alongside the lead private equity fund as well as external co-investors, who are not part of the original fund.

Co-investors can take either passive or active roles in the investment. Passive co-investors are more common, especially among LPs of the fund, as they typically have existing relationships with the lead private equity fund and may have access to co-investment opportunities as part of their overall investment strategy. However, external co-investors can also be actively involved if their expertise or resources are critical to the success of the acquisition.

Consortia comprising a private equity fund and a corporate investor are not prevalent in Kenya. This will vary depending on the specific market conditions and investment opportunities. This type of consortium combines the financial expertise and resources of a private equity fund with the strategic advantages and industry knowledge of a corporate investor.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

In Kenya, the type of consideration mechanism used in private equity transactions is dependent on the transaction structure and what the parties negotiate. The consideration structures that are predominantly seen in the market are outlined below.

Consideration Structures

Locked-box mechanisms

This consideration mechanism is generally used by private equity funds in less complex transactions in order to streamline and expedite the payment collection process as there is less risk exposure.

Earn-out mechanisms

This mechanism is used when the private equity fund would like to ensure that the vendor, usually a founder or senior management with interest in the business, is motivated in contributing to the successful performance of the business during the transition.

Closing account mechanisms

This mechanism is used by private equity funds if there are a set of complex future factors that may affect the value of the target company and the private equity fund is unwilling to take on the uncertain risk.

Fixed-price consideration

This mechanism is generally used in simple transactions with little to no risk so as to expedite completion of the transaction.

Deferred consideration
This mechanism is used mainly to bridge the valuation gap between the buyer and the seller when there are uncertainties about the target company's future performance or when the parties have different expectations about its future earnings.

Typically, the involvement of private equity funds results in the use of more sophisticated and complex consideration mechanisms. In Kenya, where the parties are not as commercially aware or do not engage counsel, fixed-price consideration structures or the use of deferred consideration through an escrow set-up are the norm.

6.2 Locked-Box Consideration Structures

In Kenya, it is not typical for interest to be charged on the equity price or reverse charge interest on any leakage that occurs during the locked-box period. If this is an element of the purchase price mechanism it is a unique element that is negotiated by the parties.

6.3 Dispute Resolution for Consideration Structures

In Kenya, it is typical to have a dedicated independent expert as an alternative dispute resolution mechanism in case there is a dispute with respect to the consideration structures in a private equity transaction. The use of an independent expert is usually separate from other dispute mechanisms such as arbitration and is limited to specific instances involving the consideration, such as how the consideration should be determined or the review of the financial statements.

If the dispute is with respect to other issues; eg, the period of time within which the consideration was determined, then the dispute will be referred to the other dispute resolution mechanism, such as arbitration, to be resolved.

Ideally, the more complex the consideration mechanism; eg, closing account mechanism, the more likely the dispute will be referred to an expert in conjunction with other dispute resolution mechanisms.

6.4 Conditionality in Acquisition Documentation

In Kenya, it is common for private equity transactions to contain conditions that need to be met before completion. These will mostly include the resolution of issues or red flags picked up during legal due diligence and will therefore vary from one transaction to another. Standard conditions in every deal include the waiver of pre-emption rights by existing shareholders, obtaining appropriate board and/or shareholder approvals and merger approvals.

In addition, certain conditions may be typical depending on certain elements of the transaction, such as:

- whether either of the entities is operating within a regulated industry that requires consent to be obtained or a notification to be lodged before completion as outlined in **3.1 Primary Regulators and Regulatory Issues**;
- whether the target company has any encumbered assets that may require the parties to notify or obtain consent from the financiers; or
- whether any of the material contracts contain change of control provisions that require parties to obtain consent or notify third parties of the proposed transaction.

Lastly, material adverse change provisions are common in Kenya, which permit the private equi-

ty fund to terminate the agreement on the occurrence of the material adverse change event. The definition of a material adverse change tends to be heavily negotiated.

6.5 "Hell or High Water" Undertakings

In Kenya, it is not typical for a private equity-backed buyer to accept a hell or high water undertaking. Private equity-backed buyers would typically exclude hell or high water provisions since merger control approval is considered mandatory when the merger meets the thresholds outlined in **3.1 Primary Regulators and Regulatory Issues**.

Further, in Kenya, we do not typically distinguish merger-control provisions from foreign investment conditions similar to other jurisdictions such as South Africa. One can, however, distinguish between the two as merger control provisions cannot be waived, whilst foreign investment conditions, which include but are not limited to obtaining requisite consents, may be waived in the event that they may result in a delay in the closing of the transaction. As outlined in **3.1 Primary Regulators and Regulatory Issues**, FSR are unlikely to impact Kenya-based transactions and are therefore not featured in foreign investment negotiations.

6.6 Break Fees

Unlike private transactions, break fees are unusual in private equity transactions in Kenya. Private equity-backed buyers will strongly oppose the payment of a fee if the transaction does not close.

6.7 Termination Rights in Acquisition Documentation

As termination rights reduce deal certainty, private equity sellers and buyers prefer to limit the circumstances that can result in the deal being terminated. Therefore, these are usually reserved for specific circumstances; ie, where the mandatory conditions (conditions precedent) stipulated in the agreement are not or cannot be fulfilled by the long-stop date – usually set three to six months from the signature date, if not extended by mutual agreement.

6.8 Allocation of Risk

Private equity buyers usually demand comprehensive warranties regarding the target's business and operational affairs. Private equity sellers typically take on minimal risk concerning the target company's operations. The warranties they provide are usually limited to affirming their ownership and lack of encumbrances on the securities being sold.

Corporate sellers will typically provide broader warranties compared to private equity sellers, although it is typical for corporates to limit the time and quantum of damages arising from a breach. Corporate buyers will also seek greater indemnification rights as compared to private equity funds to guard against any liability upon making an acquisition.

6.9 Warranty and Indemnity Protection

Please refer to **6.8 Allocation of Risk**. It is not unusual for the private equity-backed seller to provide limited warranties to a buyer on exit so as to minimise its risk exposure. The private equity-backed seller typically provides warranties with respect to:

- the ownership of the shares it is transferring;
- the status of the shares it is transferring; and
- its capacity to enter into the agreement and transfer its interest; the private equity-backed seller will usually decline to provide warranties and indemnities that are related to the

commercial operations and tax status of the target company.

As the private equity-backed seller has limited its exposure, the warranties and indemnities that relate to the operations of the target company are provided by the target company or the management of the target company, where applicable. These include but are not limited to warranties and indemnities in relation to corporate, legal and regulatory status, tax, employment, material assets, intellectual property and material contracts of the target company.

The limitations on warranties and indemnities depend on what is negotiated. In Kenya, warranties and indemnities may be limited by:

- limiting the thresholds within which the claim can be made;
- including an overall cap on liability;
- limiting the time within which a breach of warranty or indemnity can be made;
- qualifying the warranty to the knowledge of the seller; and
- qualifying the warranties with information that has been disclosed to the seller.

This is undertaken by way of a disclosure letter. It is not common to have a general disclosure of the contents and documentation shared in the data room; usually specific disclosures are required.

6.10 Other Protections in Acquisition Documentation

Further to the approach taken by private equity-backed buyers as discussed in **6.8 Allocation of Risk** and **6.9 Warranty and Indemnity Protection**, other protections in acquisition documents are outlined below.

Clawback Provisions

Acquisition documentation typically includes clawback provisions that enable private equity-backed buyers to reclaim funds by adjusting the purchase price or financial arrangements after the acquisition has completed. In the event that the equity-backed buyer is unable to receive financial compensation for the loss suffered, we have seen clawback clauses that further enable the private equity-backed buyer to acquire additional equity. This could be structured in the post-completion accounts mechanism or in the form of an option providing the private equity-backed buyer with the right to purchase the founder's shares, in the event of a breach of a warranty or indemnity, based on the loss suffered. Ideally, the put option is only exercisable for a set duration.

Warranty and Indemnity Insurance

Warranty and indemnity insurance is not common in our jurisdiction. However, in cross-border deals this is now being considered as an option where parties have utilised the warranty and indemnity insurance from international-based insurance companies.

Escrow or Retention

Private equity-backed sellers are looking to limit their risk and return their investment to their investors on exit. In this respect, their obligations are highly unlikely to be backed by an escrow or retention.

6.11 Commonly Litigated Provisions

Litigation in courts due to breach of contract and warranties is not common in private equity transactions. Parties are more willing to settle matters out of court or through alternative dispute resolution, especially since private equity-backed buyers are looking to maintain the relationship with the target company and promote growth.

7. Takeovers

7.1 Public-to-Private

Public-to-private transactions by private equity-backed bidders are uncommon in Kenya, and if they do occur, they are often kept confidential and not widely reported. However, there have been a few instances, such as Kuramo Capital Management's acquisition of a 25% stake in TransCentury PLC. In such transactions, the board is obligated to adhere to Capital Markets principles, ensuring that all shareholders are treated equally. This requires that all agreements, whether relationship or transactional, be made available to shareholders for inspection as part of the transaction process.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

The Capital Markets (Licensing Requirements) (General) Regulations, 2002 ("Licensing Regulations") specify that any person (including a private equity-backed bidder) who acquires a "notifiable interest" (ie, 3% or more) in shares in a public company or who ceases to be interested in such shares, must notify the public company of the acquisition or cessation of interest in the shares. The Licensing Regulations also require that public companies report to the NSE on a monthly basis:

- all persons who acquire or cease to have a notifiable interest in its shares;
- all directors holding 1% or more in the relevant share capital; and
- cumulative holding of the relevant share capital by directors.

Private equity-backed bidders need to be aware that this requirement under the Licensing Regulations solely applies to public companies in public transactions. However, a similar obligation is applicable to private companies with respect to beneficial ownership, as discussed in **2.1 Impact of Legal Developments on Funds and Transactions**.

Further, the Capital Markets (Securities) (Public Offers, Listing, and Disclosures) Regulations, 2002 require several types of disclosures, including:

- a quarterly disclosure to the NSE of every person who holds or acquires 3% or more of the listed company's ordinary shares;
- publication by a listed company, in its annual report, of (i) distribution of shareholders and (ii) names of the 10 largest shareholders and the number of shares in which they have an interest as shown in the issuer's register of members;
- immediate disclosure by an issuer of any information likely to have a material effect on market activity; and
- disclosure, in the annual report, of any substantial sale of assets involving 25% or more of the total assets.

7.3 Mandatory Offer Thresholds

The Takeover Regulations, as described in detail in **3.1 Primary Regulators and Regulatory Issues**, prescribe that an entity is presumed to have a firm intention to take over a public company if the entity acquires a company that holds "effective control" in a public company or, together with the shares already held by associated persons or related companies or persons acting in concert, will result in "acquiring effective control" of the listed company. The threshold of "effective control" is control of 25% of the shares in a public company.

The Takeover Regulations also prescribe circumstances under which a person is presumed to

have a firm intention to make a takeover bid. These are:

- the acquirer holds more than 25% of the shares, but less than 50% of the voting rights, and acquires more than 5% of the voting rights in the company;
- the acquirer holds at least 50% of the voting shares and acquires additional voting shares; directly or indirectly acquires a company with effective control of a listed company; and
- the acquirer obtains at least 25% of a subsidiary that has contributed at least 50% of the general turnover of the company in the previous three financial years.

7.4 Consideration

Both payment in cash and by way of shares is acceptable in Kenya. With respect to public companies, the Takeover Regulations provide that the mode of payment would need to be set out in the takeover offer document.

7.5 Conditions in Takeovers

Use of Conditions

The Takeover Regulations and the CMA do not limit the use of offer conditions in takeovers. It is common for conditions to be imposed in a takeover with respect to the minimum number of issued voting shares of the listed company, the mode of payment, regulatory approvals, and the maintenance of a minimum percentage of shareholding by the general public to satisfy the continuing eligibility requirements for listing. However, the Takeover Regulations do require the conditions to be clearly indicated in the takeover offer document and the notice of intention.

Under the Takeover Regulations, an acquirer is not allowed to announce an intention to make an offer if there are no reasonable grounds to believe that the acquirer will be able to fulfil their obligations once the offer is accepted. The acquirer is also required to demonstrate to their financial adviser that they have enough funds to ensure the takeover offer will not fail. Additionally, when presenting the offer document, the acquirer must include a statement that assures all shareholders who wish to accept the offer that the acquirer has sufficient funds to complete the takeover and that they will be paid in full; therefore, a tender offer cannot be conditional on a bidder obtaining financing.

Security Measures

With respect to listed companies, the Takeover Regulations do not forbid the implementation of measures to ensure the safety of a deal. However, it is a requirement for such measures to be revealed in both the takeover offer document and the notice of intention. Common deal security measures include exclusivity, break fees, and non-solicitation provisions. These deal security measures are also employable by private companies.

7.6 Acquiring Less Than 100%

Additional Governance Rights

If a bidder does not seek 100% ownership of the Target, the bidder may seek additional governance rights, which are typically included in the shareholder agreements or a similar agreement governing shareholder relationships, related to certain transactions, such as private equity. In cases where the buyer does not want full ownership, the buyers usually request governance rights, such as the right to have representation on the target company's board and the power to veto certain decisions.

When it comes to public M&A transactions, the CMA's Code of Corporate Governance Practices for Issuers of Securities to the Public, 2015 (the "CMA Governance Code"), requires companies

to treat all shareholders fairly, including minority and foreign shareholders. Companies are also required to fully disclose any non-compliance, and while satisfactory explanations may be considered, the mandatory provisions of the Disclosures Regulations must be followed in the CMA Governance Code.

Squeeze-Out Mechanism

The Business Laws (Amendment) Act 2020 amended the Takeover Regulations to allow the purchaser to squeeze out dissenting shareholders where the purchaser acquires 90% of the share capital of the target.

Under the Takeover Regulations, if an acquirer purchases 90% of a target company's voting shares, they must make an offer to the remaining shareholders to buy their shares at a price higher than the current market value. Although the acquirer has the right to acquire the remaining shares, minority shareholders can challenge this process by appealing to the court. In addition, notices must be given for three months starting from the day after the offer period ends or six months from the date of the offer.

7.7 Irrevocable Commitments

Usually, it is standard practice to obtain a firm agreement from both major shareholders and all shareholders in general before revealing any plans to make an offer. However, if there are any agreements related to voting, they must be disclosed in the takeover documents. For instance, after a target company's initial public offering, the target company may require current shareholders to promise not to sell their shares for a period of 24 months.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentive plans are commonly used in private equity investments in Kenya. Share option plans are most frequently implemented for management and/or the founders. The option pool is typically around between 5% and 10% of the share capital of the target company.

8.2 Management Participation

Management participation is typically structured as ESOPs allowing management the right to exercise their right to acquire shares at a fixed price, which is typically lower than the market value of the shares. ESOPs are typically structured as trusts and set out the vesting criteria for the shares in the plan.

8.3 Vesting/Leaver Provisions

Vesting Provisions

Equity incentive schemes such as ESOPS as outlined in **8.2 Management Participation**, provide managers with vesting provisions and therefore payment on exit.

Leaver Provisions

These provisions are stipulated for shareholders who hold managerial positions within the target company. The typical leaver provisions include: (i) good leaver provisions – where the manager is permitted to maintain their equity within the target company if they leave the target company in "good" circumstances; eg, retirement; and (ii) bad leaver provisions – where the manager is obligated to sell their shares to the shareholders at a price below market value if they leave the company in "bad" circumstances; eg, gross misconduct.

8.4 Restrictions on Manager Shareholders

Restrictive Covenants

In Kenya, there are no restrictive covenants provided to management shareholders. The restrictions agreed to by management shareholders are usually set out in the shareholder's agreement and the employment contract. The typical restrictive covenants are outlined below.

Non-compete clause

This clause limits the business activity that the manager can undertake after leaving the target company. The limitation is limited to a particular jurisdiction and period. It is important to note that the limitation needs to be fair so as not to impede the manager's ability to earn a living. If the clause is extensive there is a risk that the courts in Kenya may deem the clause unenforceable. Parties can negotiate for compensation to be provided on exit, in order for this clause to be binding and adhered to by the manager.

Non-solicitation

This clause prohibits the manager from soliciting the target company's employees and clients for a certain period. There are no limits to enforceability.

Confidentiality

The manager will be bound not to disclose confidential information. Usually, the clause is extensively drafted, clearly highlighting what is deemed confidential information.

Non disparagement clause

The manager is bound not to disclose or say anything negative about the target company either in private or public that may damage the target company's reputation.

8.5 Minority Protection for Manager Shareholders

Management shareholders do not typically benefit from strong minority protection of any form. They do, however, like other shareholders, enjoy some limited protection under the Companies Act, which mandates majority (50%) and special (75%) shareholder approval requirements, as well as derivative actions in the event of oppressive behaviour against the target company.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

Private Equity funds aim to ensure that their investment is protected and that the target company performs so as to make the most out of their investment. In this respect, private equity funds aim to ensure that they are aware, or in control, of the day-to-day management of the target company by instituting the following in shareholder agreements.

Board Appointment Rights

Private equity funds usually aim to have control of the board by acquiring the rights to appoint board members depending on their shareholding and usually with veto rights. They will usually negotiate board observer seats at the minimum.

Reserved Matters

Reserved matters are mostly highly negotiated. The shareholder's agreement clearly outlines what is a board-reserved matter and what is a shareholder-reserved matter. The voting threshold on reserved matters is also a point of negotiation as the private equity fund will aim to ensure that they are included in all decision-making.

Information Rights

Private equity funds usually require certain documents, such as financial statements and director reports, to be submitted at set intervals. This ensures that the private equity fund is aware of the performance of the target company.

9.2 Shareholder Liability

In Kenya, as a target company has a separate legal personality from its shareholders, shareholders are generally not liable for the actions of a limited liability company (in this case the target company). However, there is an exception, where the "corporate veil" can be pierced, and the shareholders are held liable for the actions of the Kenyan target company. This is when the shareholders have used the Kenyan target company to perpetuate fraud or circumvent statute fraudulently.

10. Exits

10.1 Types of Exit

In Kenya, the common types of exits are sales to other private equity funds or corporates. We have also seen sales to the Kenyan government with respect to equity stakes in publicly listed companies. We have not seen other forms of private equity exits, such as IPOs, auctions, dual track or triple track, in the last 12 months.

10.2 Drag and Tag Rights

It is common for private equity transactions in Kenya to have drag and tag rights. In practice, drag and tag rights are not typically enforced as minority shareholders are usually willing to collaborate with the private equity funds in the event of a proposed exit from a Kenyan investment.

10.3 IPO

We are not aware of equity funds exiting by way of an IPO in the jurisdiction. Exits are mainly undertaken through trade sales and through transactions with other financial buyers, unlike the Johannesburg Stock Exchange which has had the most PE-backed IPOs in Africa. Nevertheless, exit by way of an IPO is an option.

With respect to lock-in arrangements in the jurisdiction, the Capital Markets (Securities) (Public Offers Listing and Disclosures) Regulations, 2002 provide for a two (2) year lock-up period from the date of listing of the shares.

Trends and Developments

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Cliffe Dekker Hofmeyr (incorporating Kieti Law LLP) is a leading Kenyan law firm that provides quality, specialised and personalised legal services in key specialist areas of practice. The firm's lawyers are recognised for their depth of expertise and extensive experience in all prominent sectors attractive to private equity investors in Africa. The firm's services include fund formation, portfolio acquisitions and exits, legal and tax due diligence, follow-on acquisitions, debt and equity restructuring or refinancing and business restructuring processes. The firm handles a wide range of cross-border transactions spanning Eastern Africa and other countries such as Mauritius, Nigeria, Ghana, the UK, and Norway, among others. The continued quality of service has seen the firm recognised as the Trustlaw Regional Law Firm of the Year at the 2023 Thomson Reuters Trust Law Awards and as 2nd runner up in the Large Law Firm of the Year Category at the Nairobi Legal Awards 2022.

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2023 Deal Activity in Kenya

Private equity investment activity in Kenya and East Africa witnessed a slight uptick in 2023. According to the I&M Burbidge Capital Annual East Africa Financial Review for 2023 (IMB Review), the East African region recorded 93 private equity transactions, representing a 9.7% decrease compared to the 103 transactions in 2022. The total deal value reached approximately USD1.6 billion, a 3.5% decline from the previous year. However, the average deal value surged by 19% to approximately USD25.0 million, while the median deal value climbed by 32% to around USD9.9 million.

Venture capital, traditionally the most active investor class, experienced a substantial downturn in 2023. Transaction volume plummeted by 36% compared to the 66 deals recorded in 2022. Moreover, the total deal value contracted by a significant 76% to approximately USD170.1 million, mirroring the global trend of halved venture capital investments.

In contrast, traditional private equity deals increased by 15.4% from 26 in 2022 to 30 in 2023. Nevertheless, the total disclosed deal value decreased by 12% to USD367 million. Consequently, the median deal value dropped by 39% to USD7.5 million. The IMB Review attributes these trends to a challenging fundraising environment for Africa-focused private equity funds, resulting in a 40% decline in investor capital compared to 2022, and a depressed valuation landscape.

Exit activity remained relatively stable, with a marginal decline of 12.5% from eight exits in 2022 to seven in 2023. The buyer profile continued to diversify, with secondary buyouts accounting for 42.8% of exits, trade sales for 28.6%, and a combination of both for 28.6%. This emerging trend of combined secondary/trade sales highlights a growing focus on exit opportunities at the investment stage.

2024 Deal Activity So Far

Deal activity in Kenya experienced a downturn in the first half of 2024. The IMB Review reports a decline in both deal volume and value compared to the same periods in 2022 and 2023. Specifically, the number of deals recorded in H1 2024 totalled 68, a decrease from the 75 deals in H1 2023 and 72 deals in H1 2022. Disclosed deal values also dropped significantly, plummeting by 71.6% from the record high of approximately USD3.6 billion in H1 2023. Private equity activity was particularly impacted, with a 25% decline in deals compared to H1 2023.

From a sector perspective, agribusiness emerged as the most active sector in the first half of the year, securing approximately USD238 million in deal value. Following close behind were the energy and manufacturing sectors, with deal values of approximately USD156 million and USD229 million, respectively.

Trends: Civil Unrest and Economic Implications

In June 2024, Kenya experienced significant civil unrest triggered by the proposed Finance Bill 2024 (the "Finance Bill"). Introduced on 9 May and passed by Parliament on 25 June amidst widespread protests, the Finance Bill outlined substantial tax increases, including VAT on essential items like bread and levies on diapers and sanitary towels. These measures threatened to exacerbate the cost of living crisis.

Responding to two weeks of nationwide demonstrations, President William Ruto announced the withdrawal of the Finance Bill on 26 June. This decision marks a critical juncture in Kenya's

budgetary process. The Finance Bill aimed to generate KES346 billion in additional revenue to support a KES3.68 trillion budget. The Kenyan government must now explore alternative funding sources, such as increased borrowing or spending cuts, to address this shortfall, and is expected to revise the recently approved budget estimates and implement austerity measures.

While the protests may have temporarily dampened investor sentiment, particularly among foreign investors with diverse global options, the demonstrations have undeniably catalysed significant positive change. It is evident that the public's voice has been amplified, demanding a higher standard of transparency and inclusivity in the policymaking process. As a result, future finance and tax legislation will likely undergo more rigorous public consultation and scrutiny. Moreover, the protests have shone a spotlight on the imperative for enhanced governance and accountability among public officials.

Legal and Regulatory Developments

Regulation of alternative investment funds

In December 2023, the Cabinet Secretary for the National Treasury and Planning introduced the Capital Markets (Alternative Investment Funds) Regulations, 2023 (the "AIF Regulations"), to oversee the regulation of alternative investment funds (AIFs) by the Capital Markets Authority (CMA).

An AIF is "a collective investment scheme that privately pools funds from at least two but not more than one hundred investors in Kenya or outside Kenya to invest on the investor's behalf in accordance with a defined investment policy statement". Under the AIF Regulations, the CMA has the authority to issue approval for any entity seeking to operate an AIF.

This definition is fairly broad and appears to capture any entity that pools funds from investors for purposes of investment. The explanatory memorandum issued by the National Treasury in relation to the AIF Regulations indicates AIFs are considered to be a subset of collective investment schemes (CIS). CISs are publicly pooled funds collected by a licensed entity from investors, mostly retail investors to be invested in a range of investment asset classes, such as bonds, equities and cash equivalents.

AIFs are seen as a subset of CISs that invest the pooled funds in "non-traditional" asset classes, such as infrastructure, private equity, real estate and commodities. In this regard, the AIF Regulations encompass a broad spectrum of fund types, including debt, equity, hedge, property, and infrastructure funds, as well as other alternative investment structures.

Given the generality in the definition of an AIF, it is unclear whether the AIF Regulations would apply to private equity funds and require any fund established in Kenya and pooling money from Kenyan investors to be registered by the CMA in accordance with the AIF Regulations. However, there have been previous amendments to the Capital Markets Act aimed at regulating private equity activity. In 2022, the CMA gained authority to license and oversee private equity funds accessing "public funds". While what constitutes "public funds" remains undefined, legislative discussions indicate a focus on safeguarding public funds invested by entities like pension schemes. These schemes can allocate up to 10% of their assets to private equity or venture capital investments. Implementing the AIF Regulations is expected to present challenges due to the diverse range of entities covered and the interplay with existing capital markets regulations.

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Taxation of private equity funds

A recent Tax Appeals Tribunal (TAT) ruling had introduced significant challenges for private equity (PE) funds operating in Kenya.

In ECP Kenya Limited v Commissioner of Domestic Taxes (Tax Appeal No 335 of 2022), the TAT determined that ECP Fund, a Mauritius-based PE fund, was subject to Kenyan corporate income tax on gains from the sale of its stake in Java House Mauritius Limited. This decision was primarily based on the finding that ECP Kenya, the fund's local adviser, exercised sufficient control over the fund to establish a permanent establishment in Kenya.

By reclassifying investment gains as business income, the TAT has introduced a higher tax burden on PE investments, as such gains are subject to corporation tax at 30%. Furthermore, the decision to attribute a permanent establishment to the fund based on the activities of its local adviser creates uncertainty about the tax residency of PE funds and their potential exposure to Kenyan tax on worldwide income. The ruling of the TAT is currently under appeal in the High Court of Kenya.

Unconstitutionality of Finance Act 2023

On 31 July 2024 the Court of Appeal of Kenya issued a judgment declaring the entire Finance Act, 2023 (the "Finance Act"), unconstitutional. The Finance Act, which was signed into law on 26 June 2023, amended various tax laws to introduce revenue-raising measures for the fiscal year 2023/24 and going forward.

Aggrieved by the legislative process leading to its enactment, 11 constitutional petitions were filed in the High Court challenging the Finance Act's constitutionality. This culminated in a judgment delivered by the High Court on 28 November 2023. Aggrieved by the High Court's decision, the government made an appeal to the Court of Appeal (CoA). The CoA dismissed the appeal and declared the entire Finance Act to be unconstitutional on various grounds, including the failure to engage in public participation regarding certain provisions introduced into the draft law before it was passed.

Given that the entire Finance Act, 2023, was declared unconstitutional by the Court of Appeal, the following measures that would have impacted private equity investments are no longer applicable:

- the broadening of the scope of capital gains tax (CGT) on any profits obtained by a shareholder through selling shares of a Kenyan company; this applied if the shareholder had a direct or indirect ownership of at least 20% of the company's share capital at any time within one year before the sale; and
- notification of transactions involving the sale of at least 20% of the shares of a Kenyan company to the Commissioner-General of the Kenya Revenue Authority.

With the Finance Act, 2023, being declared unconstitutional and with the withdrawal of the Finance Bill, 2024, the tax laws as amended by the Finance Act, 2022, are now the operational statutes for tax collection and administration purposes.

East Africa Community Competition Authority

The East African Community Competition Act of 2006 governs the supervision of merger activities within the East African Community (EAC). It mandates that any merger or acquisition that has a cross-border effect in the East African Community be notified to the East African Community Competition Authority (EACCA).

Presently, notifications for merger transactions within the EAC Member States (ie, Kenya, Uganda, Tanzania, Rwanda, Burundi, South Sudan and the Democratic Republic of Congo) are not required, although 2023 saw the EACCA enter into bilateral agreements with each of the competition authorities of Kenya, Tanzania, Rwanda, Tanzania and Rwanda to foster harmony in the execution of their respective mandates and to lay the framework for adopting a single merger notification regime. This would ensure a lack of dual notification requirements on the operationalisation of the EACCA. It remains to be seen whether the EACCA will enter into similar arrangements with other regional competition regulators, such as the COMESA Competition Commission.

Conclusion

The Kenyan private equity landscape has been characterised by significant volatility in 2023 and the first half of 2024. While a slight uptick in deal activity was observed in 2023, this trend reversed sharply in the first half of 2024, coinciding with a challenging economic climate and political instability.

The introduction of the Capital Markets (Alternative Investment Funds) Regulations, 2023, signifies a step towards a more regulated private equity environment, but its practical implementation remains to be seen. Furthermore, the recent tax-related developments, including the ECP Kenya case and the subsequent invalidation of the Finance Act, 2023, introduce significant uncertainties for private equity investors. These factors, coupled with the evolving regulatory landscape, suggest a complex and dynamic investment environment in Kenya.

Overall, the private equity industry in Kenya faces a period of readjustment as it navigates these challenges and adapts to the new normal.

LUXEMBOURG

Law and Practice

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

As of 2024, Luxembourg continues to solidify its position as a hub for private equity and M&A activities. The jurisdiction's appeal is largely due to its political and economic stability, favourable tax environment and sophisticated legal framework, which collectively provide an attractive landscape for international investors and companies.

In the current year, a sustained interest in private equity investment funds has been observed, with unregulated funds being the most utilised format. There is a particular emphasis on special limited partnerships (SCSps), which offer significant legal flexibility as well as tax transparency, and are the go-to form of European fund for a global audience of managers and investors.

On the M&A side, share deals involving Luxembourg-resident asset-holding entities remain prevalent. Typically, however, although the holding entity may be located in Luxembourg, the assets are not.

Sectors that have garnered significant attention from investors include fintech, biotech, and sustainable energy, reflecting a global shift towards innovation and sustainability, while areas like healthcare and broader technology also remain popular. Moreover, funds that focus on structured debt and credit continue to attract investors, benefiting from the sophisticated financial infrastructure and the high quality (and often bespoke) fund service capabilities that Luxembourg offers.

Despite a broader interest in diverse investment opportunities, most private equity sponsors in Luxembourg maintain a disciplined approach, adhering to their core investment strategies. There is, however, a noticeable trend towards sector-agnostic investments, as some firms seek to capitalise on special situations and unique opportunities that promise high returns, irrespective of industry.

1.2 Market Activity and Impact of Macro-Economic Factors

There has been a notable slowdown in transactions in the past two years. In 2024, high interest rates and other macroeconomic factors, such as inflationary pressures and supply chain disruptions, had a significant impact on private equity deal activity. These elements have introduced a degree of caution among investors, leading to more rigorous due diligence processes and a heightened focus on the sustainability of target companies' cash flows.

Geopolitical uncertainties and events have also played a role in shaping investment decisions. Investors are increasingly considering political stability and regulatory environments when evaluating potential deals.

Despite these challenges, the resilience of the private equity sector in Luxembourg is evident. The jurisdiction's ability to adapt to changing economic conditions and its commitment to providing a supportive ecosystem for private equity transactions continue to underpin its status as a leading destination for investment in Europe.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Over a number of years, Luxembourg has taken steps to position itself as Europe's leading loca-

tion for both private equity fund vehicles and asset-holding vehicles. Luxembourg partnerships – in particular the SCSp and (albeit to a lesser extent) the simple limited partnership – have become the go-to form of entity for private equity-pooling vehicles, while private limited liability companies (SARLs) remain the preferred asset-holding vehicles for private equity funds globally.

The introduction of the Alternative Investment Fund Managers Directive (AIFMD)-compliant Reserved Alternative Investment Fund (RAIF) regime in 2016 added another available option, and this form is often used by private equity sponsors for pooling vehicles, especially in the context of pan-European marketing to professional investors.

While there has been some movement and developments at European level that impact private equity funds (AIFMD 2.0 and, to some extent, ELTIF 2.0), over the past 12 months, Luxembourg has not implemented any significant changes to its laws or regulations that would impact private equity investment vehicles or their managers.

In the area of taxation, we have noted a continued interest in RAIF funds in non-transparent forms, such as the corporate partnership limited by shares ("SCA") and the public limited company ("SA"). These structures allow for more flexible navigation in the structuring and financing of downstream investments, particularly in light of anti-hybrid rules.

The year was also marked by the entry into force of the new double tax treaty between Luxembourg and the UK, as well as the introduction in Europe of the Global Anti-Base Erosion (GloBE) rules via Council Directive (EU) 2022/2523 of 14 December 2022, known as the "Pillar 2 Directive". This directive provides for a minimum effective taxation applicable to multinational groups and large-scale domestic groups with a presence in the EU and having a minimum consolidated revenue of more than EUR750 million. Like most EU member states, Luxembourg has implemented the Pillar 2 Directive by means of the law of 22 December 2023 on effective minimum taxation, which is applicable to fiscal years starting on or after 31 December 2023.

Finally, the new Luxembourg government, appointed at the end of the year 2023 for a term of five years, has committed to reinforcing Luxembourg's attractiveness with a series of tax measures and reforms, such as a gradual reduction in the corporate income tax rate, beginning in 2025 with a reduction from 17% to 16%. This will lead to an overall maximum combined corporate income rate of 23.87% for 2025 (in Luxembourg City), compared with the current 24.94%.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

The *Commission de Surveillance du Secteur Financier* (CSSF) is Luxembourg's regulator for financial services (in addition to other roles). The CSSF has regulatory oversight and, in that capacity, has responsibility for product-regulated investment funds such as specialised investment funds (SIFs) and investment companies in risk capital (SICARs), as well as for investment fund managers located in Luxembourg.

However, the CSSF's oversight authority does not extend to limited partnerships that are not subject to product regulation, nor does it extend

to RAIFs (nevertheless, RAIFs' management companies are still subject to regulatory oversight by the relevant financial regulator of the home jurisdiction of the relevant management company – which would be the CSSF for all Luxembourg-based management companies). In a similar fashion, M&A activity would be subject to the relevant rules and regulations in the home jurisdiction of the target entity.

There are no specific rules or restrictions that apply specifically to private equity transactions in Luxembourg, but relevant sanctions and the usual anti-money laundering (AML) and "know-your-client rules" do, of course, apply in the same way as for any transaction. Where multiple AML supervisory regimes come into play in the context of a given transaction, compliance with each regime will be required by the applicable parties.

Following the implementation of the Law of 19 December 2019 and given the situation in Ukraine, there has been an increase in awareness of the need to comply with the Luxembourg sanctions regime. The Law of 20 July 2022 established a Luxembourg financial sanctions committee, which is responsible for monitoring the implementation of financial sanctions issued by the United Nations Security Council, the EU and the Luxembourg Ministry of Finance. There has also been an increased focus on sanctions evasion risk following the Russian invasion of Ukraine. Antitrust regulations would, in the same way, be applied in accordance with the relevant rules in the appropriate jurisdictions.

4. Due Diligence

4.1 General Information

In Luxembourg, legal due diligence is usually of secondary importance to financial and tax due diligence, but it is still carried out and typically consists – in addition to the usual practice of verifying corporate existence, the compatibility of corporate objects, and solvency – of reviewing the corporate governance and past and current activities of the target for compliance with Luxembourg laws and regulations.

The due diligence is usually conducted first via a review of the publicly available documentation (ie, the documents that are required to be filed at, and are available for download from, the Luxembourg Trade and Companies Register), followed by a thorough review of the documentation made available in the data room. Key areas of focus for legal due diligence include:

- company corporate documents – this encompasses the review of the company's articles of incorporation, minutes of shareholders' and board meetings, and any other essential corporate documents to ensure they are up to date and in order;
- regulatory status – ensuring that the company is in compliance with all relevant regulations, including those specific to its industry, and that it has all necessary licences and permits to operate;
- financing arrangements – reviewing the company's financing structures, including existing loans, credit facilities and security interests, to understand the financial obligations and any potential liabilities that may affect the transaction; and
- litigation – conducting investigations into any past, present or potential future litigation that

the target may be the subject of or that might affect the target.

In addition to legal due diligence, tax due diligence is an essential process for investors and companies considering mergers, acquisitions or partnerships. While red flag tax due diligence allows for a quick assessment of major potential concerns and is increasingly becoming the norm, conducting a comprehensive tax due diligence is key not only for gaining an in-depth insight into the tax implications of a transaction but also for facilitating effective post-acquisition restructuring.

4.2 Vendor Due Diligence

Vendor due diligence is an intricate part of practice in private equity transactions in Luxembourg. Advisers will usually rely on vendor due diligence reports if the adviser is of the opinion that the third party who conducted the due diligence is reliable, but at least some independent verification is now the rule rather than the exception.

Auction sales are very, very rare in Luxembourg, and vendors typically only provide a summary corporate due diligence report. There is generally more focus on financial data for auction sales.

5. Structure of Transactions

5.1 Structure of the Acquisition

In Luxembourg, the landscape of private equity acquisitions has remained relatively stable, with most acquisitions by private equity funds being carried out through private treaty sale and purchase agreements negotiated between the parties. Auction sales are less frequent in Luxembourg as very few targets – as opposed to the holding structures – are located in Luxembourg.

5.2 Structure of the Buyer

In Luxembourg, the landscape of private equity acquisitions has remained relatively stable, with most acquisitions by private equity funds being carried out through private treaty sale and purchase agreements negotiated between the parties. Auction sales are less frequent in Luxembourg as very few targets – as opposed to the holding structures – are located in Luxembourg.

5.3 Funding Structure of Private Equity Transactions

Private equity deals are mainly funded through a mix of equity and debt. An equity commitment letter providing contractual certainty of funds is required in the majority of deals. In most transactions in Luxembourg, the private equity fund (together with its co-investors, if applicable) will seek to acquire a majority interest – or, even better, a 100% interest – as opposed to a minority stake, as sponsors tend to value control over the destiny of their investment and the certainty that a majority or outright shareholding can bring.

In many deals, debt funds will commit at signing but, in instances where debt funds are not yet confirmed, bridge funding is often provided by the equity shareholders.

Over the past year, the financing markets for private equity deals have faced challenges due to the increased cost of debt and the reduced accessibility of liquidity in debt markets, given the current interest rates; however, the fundamental approach to financing has not undergone significant changes.

5.4 Multiple Investors

Although some transactions will involve a consortium of private equity sponsors, the majority of deals are still concluded by a single sponsor. In the recent past, there has been a steady

increase in co-investments, either between more than one sponsor or with sponsors and their limited partners.

Deals involving co-investments by other investors alongside the private equity fund's investment constitute an increasing proportion of the total transactions. In Luxembourg, both are in evidence, with co-investments between more than one sponsor and co-investments between a sponsor and its own investors increasing year-on-year both in number and as a proportion of the whole. Consortia that include both private equity funds and corporate investors are also present in the market, although they are not the norm.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

In Luxembourg, there is no predominant form of consideration structure used in private equity transactions, as the consideration mechanism will depend very much on the general strategy adopted by each sponsor and the specific requirements of the transaction. It follows that both locked-box and completion accounts mechanisms are seen on a regular basis in transactions involving Luxembourg holding and pooling vehicles. In addition, earn-outs are commonly included where one or more of the founders remain either as minority shareholders or as part of the management group of the target.

The involvement of a private equity fund (whether as seller or as buyer) can affect the type of consideration mechanism used, in that, depending upon the circumstances of the transaction and, in particular, the size of the sponsor and the deal itself, the type of consideration mechanism might be imposed upon the seller rather than driven by the seller.

A private equity seller will generally provide the same types of protection in relation to the various consideration mechanisms as would be offered by a corporate seller.

Similarly, a private equity buyer will generally provide the same types of protection in relation to the various consideration mechanisms as would be offered by a corporate buyer.

6.2 Locked-Box Consideration Structures

Locked-box consideration structures are less common in Luxembourg, with closing accounts still being the preferred option, as they are typically seen as being "fairer" to both parties. If a locked-box consideration mechanism is used, then it would not be common practice for interest to be charged on leakage.

6.3 Dispute Resolution for Consideration Structures

Alternative dispute resolution is in its infancy in Luxembourg and, probably for that reason, separate dispute resolution mechanisms in the transaction agreements are rare regardless of whether a locked-box consideration mechanism or a completion accounts consideration mechanism is used.

Typical wording in the transaction documents would envisage an immediate recourse to the Luxembourg court system (it is also not usual for Luxembourg transactions to include reference to a choice of foreign law or jurisdiction). However, as awareness of alternative dispute resolution grows in Luxembourg, the inclusion of specific dispute resolution mechanisms in private equity

transaction documents in the country is increasing in prevalence.

6.4 Conditionality in Acquisition Documentation

It is common for private equity transactions in Luxembourg to include relevant regulatory conditions. In addition, if the target itself is located in Luxembourg, then shareholder approval requirements are also not uncommon to ensure compliance with the relevant provisions of Luxembourg company law. However, such shareholder approval requirements are often superfluous, particularly if the seller typically owns sufficient equity for separate and specific approvals not to be required (as is often the case).

Material adverse change/effect provisions are fairly common.

It would be unusual for a deal in Luxembourg to be conditional upon third-party consents, such as those of key contractual counterparties. In practice, the lack of such clauses is often due to the fact that key contracts do not usually provide that consent needs to be obtained in the event of a change of control.

6.5 "Hell or High Water" Undertakings

In those deals where there is a regulatory condition, it would be unusual for a private equity-backed buyer to accept a "hell or high water" undertaking in Luxembourg. It would be much more common for completion to be conditional upon the necessary approvals and contractual requirements being fulfilled; the use of clauses in the transaction documents to stipulate such approvals and requirements (including qualitative conditions) is standard practice.

6.6 Break Fees

In such conditional deals with a private equity-backed buyer, neither break fees nor reverse break fees are common. Instead, it is typical for both parties to incur the risks of their costs and expenses until the conclusion of the transaction (and the completion of all relevant conditions). Any break fees that are envisaged must comply with the usual contract law requirements.

In addition, both break fees and reverse break fees should not impose unrealistic penalties, as Luxembourg law provides for the possibility for an excessive contractual penalty – such as a financial sanction that is out of proportion to the loss or harm caused – to be reduced by the courts, even down to an amount of zero.

6.7 Termination Rights in Acquisition Documentation

A private equity seller or buyer may typically only terminate the acquisition agreement in Luxembourg in limited circumstances, including the triggering of a specifically planned escape clause in the transaction documents, not meeting a condition imposed in the agreement between the parties, or (in much rarer circumstances) due to the complete frustration of the object of the agreement. Typically, the long-stop date would depend largely on the nature of the target (private business versus listed entity/regulated activities), and it could range from 6 to 18 months.

6.8 Allocation of Risk

Typically, risk is shared equally, regardless of whether the buyer and sellers are private equity funds. Of course, the share of risk may be pushed further in one direction or another, depending upon the relative bargaining strength of the parties.

The main limitations on liability for the seller will relate to the financial exposure (which would typically be capped) and the length of the liability exposure (which would not generally be limited to a period of two years). The exceptions to these general rules are tax matters, where the relevant period of the statute of limitations will apply and will set the time limit for any liability – which, of course, would probably be to the state rather than the other party. The seller will also typically seek to exclude liability for any known facts resulting from the content of the data room provided to the buyer.

6.9 Warranty and Indemnity Protection

Warranties from a private equity seller to a buyer upon exit are typically limited to the accuracy, completeness and veracity of the information provided to the buyer, and are usually limited in their duration (typically one to two years). The exception, as mentioned in **6.8 Allocation of Risk**, can be tax matters, where the warranties are often extended up to the expiration of the relevant limitation period. Warranties are also usually capped to between approximately 25% and 100% of the acquisition price.

It is unusual for a management team to provide warranties. Instead, earn-out mechanisms and similar contractual provisions typically provide some level of comfort in terms of the management team's sincerity and commitment by aligning the management team's interests with those of the buyer. Any warranties provided by the management team are likely to be heavily limited and/or capped; after all, in most circumstances, it will not be possible to require the management team to become parties to the acquisition contract, and such participation would need to be carefully negotiated.

Whether or not the buyer is also a private equity fund would typically not change the above situation.

Full disclosure of the data room is usually allowed against the warranties.

6.10 Other Protections in Acquisition Documentation

Indemnities from a private equity seller are not common, and even less so from the management team, although, as mentioned in **6.1 Types of Consideration Mechanisms**, earn-out and price adjustment mechanisms may be included in the deal structure if the management team stays on post-transaction or if future revenue is to be taken into account.

Warranty and indemnity insurance is becoming increasingly common in Luxembourg, following the trend in most European jurisdictions. This is perhaps not surprising as the majority of targets – as opposed to the holding structure – are located outside of Luxembourg.

Payment retentions and escrow accounts are utilised much more frequently, with escrow amounts sometimes being held back for more than a year if necessary – eg, until certain post-completion conditions, such as business, tax or any other warranties to back the obligations of a private equity seller, have been met.

6.11 Commonly Litigated Provisions

Litigation in connection with private equity transactions is extremely rare in Luxembourg, notwithstanding the absence of alternative dispute resolution mechanisms in most contracts.

The provisions that are most commonly disputed, even if the dispute does not actually mature into full litigation before the courts, are without

doubt those regarding the calculation of the consideration. In turn, disputes over the calculation of the consideration are often based on underlying disputes over the closing accounts that then impact on a closing account consideration mechanism.

7. Takeovers

7.1 Public-to-Private

Public-to-private transactions remain rare in Luxembourg, except (to a limited extent) in relation to utilities and infrastructure assets.

As for all other types of transactions, the target company's board of directors plays a crucial role in evaluating and approving the transaction and has a fiduciary duty to act in the best interests of the company. The board of directors is responsible for reviewing the terms of the acquisition offer and conducting due diligence in particular.

Relationship agreements between the bidder and the target are not very common and are not mandatory, but in some cases, the parties may decide to enter into an agreement to govern their interactions during and after the acquisition process in order to provide clarity and protection for both parties involved.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

In a Luxembourg *société à responsabilité limitée* (limited liability company), all shareholders must be disclosed to the publicly accessible Registre de Commerce et des Sociétés de Luxembourg. In a Luxembourg société anonyme (public limited company), no shareholders need to be disclosed. Pan-European reporting obligations need to be met and, as mentioned in **2.1 Impact on Funds and Transactions**, there is a new obligation to disclose the beneficial owner(s) of all Luxembourg entities.

In addition, for public companies incorporated in Luxembourg and listed in Luxembourg or any other EU member state, any shareholder having an entitlement to vote must notify both the company issuing the shares and the CSSF of any acquisition, transfer or similar operation concerning such shares or rights that causes that shareholder's holding to reach, exceed or fall below the thresholds of 5%, 10%, 15%, 20%, 25%, 33.33% (one-third), 50% and 66.66% (two-thirds).

7.3 Mandatory Offer Thresholds

As in most other EU countries, Luxembourg has adopted and imposed a mandatory offer threshold, which provides that any person reaching or exceeding a total of 33.3% (one third) of the voting rights of a listed company, further to an acquisition, transfer or similar operation, has to make a mandatory offer to acquire all the remaining shares of that company at a price at least equivalent to the highest price paid by that person for the same shares over the period of 12 months immediately prior to this mandatory offer.

7.4 Consideration

The vast majority of private equity transactions involving Luxembourg funds and holding entities are cash transactions, but share deals are not uncommon. If the consideration consists of securities that are not admitted to trading on a regulated market, the consideration shall also include a cash alternative. There are no minimum price rules applicable to tender offers in Luxembourg.

7.5 Conditions in Takeovers

In a private equity-backed takeover offer, the percentage of shares a bidder is willing to acquire is not restricted under Luxembourg law (except for mandatory offers, as explained in **7.3 Mandatory Offer Thresholds**); therefore, a bidder may specify in its offer the minimum percentage of shares that it is seeking to acquire. Other offer conditions may be set out, and often are, especially when clearance from competition authorities is required.

However, a takeover offer may not be conditional upon the bidder obtaining financing; a buyer therefore needs to ensure that financing is in place.

The most common security measures sought by bidders are break fees, which are permitted and not specifically regulated under Luxembourg law (with the exception of the provisions on penalties, as mentioned in **6.6 Break Fees**). However, the board of directors of the target company should consider carefully before agreeing to accept break fees, as it could be deemed as not being in the best corporate interest of the target company unless, in the circumstances in which the break fees are triggered, the termination of the agreement is also in the best corporate interest of the target company.

7.6 Acquiring Less Than 100%

If a bidder does not seek or ultimately obtain 100% ownership of a target, then the main additional governance right a private equity bidder could seek outside of its shareholding is the right to present a list of candidates for board-level director positions at the shareholders' meetings.

A bidder willing to acquire the entire ownership of a target can force the other shareholders to sell their shares to the bidder when the bidder has acquired at least 95% of the capital carrying voting rights and 95% of the voting rights of the target. However, if a target has issued more than one class of securities, then the "squeeze-out" right applies individually to each class of securities.

Thresholds vary according to the type of entity, but typically for an SA and a SARL, which are the most common forms of targets, the threshold for the bidder to be able to do a debt push-down would be 66.6% of voting rights in an SA and 75% in a SARL.

7.7 Irrevocable Commitments

It is quite common for the bidder to seek irrevocable commitments from the principal shareholders of the target to tender or vote. However, there is no provision in Luxembourg law ensuring the enforceability of such commitments, so damages could ultimately only be awarded in the event of a breach of the commitment – compulsion via a mandatory injunction is not possible. The negotiation of such commitments in the case of a voluntary takeover offer is usually undertaken at the pre-bid stage.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentivisation of the management team is a common feature of private equity transactions in Luxembourg, but the level of incentive would generally be limited to between 5% and 20% of the equity, depending on the size of the transaction, the industry, the specific company's growth prospects, and the negotiation between the private equity investors and the management team.

8.2 Management Participation

Management participation in private equity transactions is typically structured via both sweet equity (ordinary shares and/or options issued at a lower price to management to create motivation to increase the value of the acquired company with the incentive of a higher price on exit) and institutional strip (corresponding to the cash injected by the private equity investors to acquire the target, although key management may also be required to invest in the target to bind their interests to those of the private equity investors) in Luxembourg-based deals, depending in the main upon the private equity strategy.

In the same way, managers could be offered ordinary equity, but with limited participation that would not trigger any blocking thresholds in terms of decisions or preferred equity deprived of voting rights but granted with incentive financial rights. In the latter case, the preferred instrument used would be preferred shares with no voting rights and preferred rights to dividend. This structure enables managers to share in the financial success of the company while maintaining a clear separation between ownership and control.

The use of these instruments is subject to ongoing evolution, reflecting changes in market conditions, regulatory frameworks and the strategic objectives of private equity investors. It is important to note that the specific terms and conditions of sweet equity and institutional strip arrangements, as well as the use of preferred instruments, can vary significantly from one transaction to another. These structures are often complex and tailored to the unique circumstances of each deal, taking into account the objectives of all parties involved.

8.3 Vesting/Leaver Provisions

The typical leaver and vesting provisions for management shareholders would grant options that would vest with a minimum period of three years (sometimes extended to five years). The award agreement may contain performance goals and measurements such as sales, earnings, return on investment or earnings per share. The exercise period is generally quite long (up to ten years for certain structures). However, all vested-but-not-exercised rights would be lost as soon as the holder ceases to be employed by the company or an affiliate.

8.4 Restrictions on Manager Shareholders

In terms of restrictive covenants agreed to by management shareholders, non-compete and non-disparagement undertakings are often part of the contractual arrangements. However, enforcement can sometimes be difficult, with prohibitive injunctions generally available only under limited circumstances.

Non-compete clauses, in any event, need to be limited to the Luxembourg territory, and for a limited period of time that needs to be agreed as reasonable. A non-compete clause that would prevent the manager from being able to work because it is too broad, either in scope or in time, will not be enforceable. Non-solicitation clauses are less strictly regulated and are therefore often included and more liberally applied.

Restrictive covenants would typically be part of both the equity package and employment contract.

In conclusion, while restrictive covenants are a common and necessary feature of agreements with management shareholders in Luxembourg, their enforceability hinges on a balance between

protecting the company's interests and ensuring that the restrictions do not unreasonably impede the individual's ability to work and compete in the market. It is essential that these covenants are drafted with precision and a clear understanding of the legal framework within which they operate.

8.5 Minority Protection for Manager Shareholders

Manager shareholders are not usually granted greater protection than other minority shareholders. It is worth noting that, under Luxembourg law, minority shareholders do not benefit from any form of special protection regime; there is only an anti-dilution mechanism provided in the law for shareholders in a société anonyme.

On a contractual basis, an anti-dilution mechanism could be agreed upon between the shareholders, but in most deals it is unusual for a majority shareholder to agree to such an anti-dilution mechanism on a voluntary basis. In the same way, management rarely enjoys veto rights, except over a limited number of matters related to the business.

The typical deal structure of a private equity transaction would not allow a management team to have a right to control or influence the exit of the private equity fund as the fund will, on the contrary, wish to ensure that it has full freedom to decide the time, form and mechanism of its exit.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

Assuming that it has at least a majority shareholding, a private equity shareholder ultimately has total control over a portfolio company, although it would be unusual for the shareholder to interfere in the operations of the board on a day-to-day basis.

A private equity fund shareholder would generally, as a minimum, have the final say in the majority of the appointments to the portfolio company's board, thus indirectly ensuring control over the management.

When only a minority stake is taken, the private equity shareholder will typically require a right of veto over key decisions, whether at board or shareholder level, such as the disposal of assets, entering into new or amended financing arrangements, a change in key executives, or the entering of new investors into the structure.

9.2 Shareholder Liability

The concept of a separate legal identity for a corporation is recognised and enforced in Luxembourg, and the corporate veil would only be pierced in extreme circumstances in the event of insolvency of the company and actions inconsistent with the position of the shareholder on the part of the fund.

Limited partners of a limited partnership are generally only liable for the debts of the partnership if they have interfered in its management, and a (non-exclusive) list of limited partner prerogatives is enshrined in law. Shareholders of limited liability companies generally have the ability to influence the actions of the company via their voting rights.

10. Exits

10.1 Types of Exit

The authors are not aware of any other form of private equity exit other than a sale to other private equity-backed investors or corporates in the past 12 months. The typical holding period for private equity transactions before the investment is sold or disposed of varies depending upon a variety of factors. Due to a slowdown in M&A activity, coupled with valuation challenges over the last few years, this period has increased from an average of three to five years to five to seven years.

The most common form of private equity exit is via a share sale to a third party (often a secondary transaction with another private equity sponsor). IPOs are becoming more and more frequent, in part due to the growth of the capital market's appetite for technology and healthcare businesses in particular. Dual-track exits – ie, an IPO and sale process running concurrently – are unusual.

Depending upon the terms of the fund and the timing of the transaction, private equity sellers typically reinvest as soon as a suitable new target has been identified and the terms of the new transaction agreed.

10.2 Drag and Tag Rights

Drag-and-tag rights are typical in equity arrangements, although rarely enforced, with a sale of all shares with the consent of all shareholders being more usual. There is no typical drag or tag threshold in Luxembourg, although the majority control threshold would be more frequent than other thresholds. The threshold usually depends on the terms of the transaction.

10.3 IPO

On an exit by way of IPO, the typical lock-up arrangement will seek to prevent insiders from selling for a minimum period of between three and six months. In addition, where the seller retains a significant interest, a relationship agreement would be expected for the benefit of the new investors. Regulatory requirements often drive lock-up periods; where regulatory requirements dictate, most transactions do not extend lock-ups beyond the regulatory periods.

It should be noted that the IPO would very rarely take place in Luxembourg; in most of the cases, the IPO will be on a major market such as New York, London or Paris and therefore led by the regulations of the jurisdiction chosen for the IPO.

Trends and Developments

Contributed by:
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GSK Stockmann is a leading independent European corporate law firm with more than 250 professionals across offices in Germany, Luxembourg and the UK. It is the law firm of choice for real estate and financial services, and also has deep-rooted expertise in key sectors such as funds, capital markets, public, mobility, energy and healthcare. For international transactions and projects, GSK Stockmann works together with selected reputable law firms abroad. In Luxembourg, it is the trusted adviser of leading financial institutions, asset managers, private equity houses, insurance companies, corporates and fintech companies, with both a local and international reach. The firm's lawyers advise domestic and international clients in relation to banking and finance, capital markets, corporate/M&A and private equity, investment funds, real estate, regulatory and insurance matters, as well as tax.

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Luxembourg Private Equity Market Status

Private equity has increased in importance within the Luxembourg finance and fund industry during recent years and the Luxembourg-based Private Equity investment funds have become more and more attractive for institutional and professional investors worldwide. The asset class is still not yet easily accessible to retail investors, but the introduction of AIFMD II, ELTIF 2.0 and the EU Retail Investment Strategy, together with the modernisation of the Luxembourg fund toolbox (adoption of the bill of law no 8183 in July 2023), are set to enable retail investors to engage alternative asset classes, which are also deployed by private equity providers.

Luxembourg is a well-recognised financial centre and the number-one domicile for investment funds within Europe. Sponsors, investment managers and investors from Europe, the USA and Asia use Luxembourg to structure their investments and respective vehicles.

As of May 2024, the net assets of regulated Luxembourg investment funds, including alternative investment funds (AIFs) and undertakings for collective investments in transferable securities (UCITS), amounted to more than EUR5,472 billion. Assets under management of all Luxembourg funds (regulated and unregulated) grew to EUR5.485 trillion in March 2024 which reflects the highest amount which was reached since 2021.

Around a quarter of the Luxembourg AIF's market is made up of private equity funds. According to Preqin, Luxembourg is the domicile of 51.5% of all European Private Equity funds. Luxembourg's private equity and venture capital funds increased by 5.7% until end of 2023 compared to December 2022 according to the Luxembourg fund association ALFI and the financial supervisory authority CSSF. It is expected that private equity should even be the primary driver of growth with regard to alternative asset classes from the perspective of Luxembourg alternative investment fund managers (AIFMs) and management companies. One has to note that until around 15 years ago private equity meant the acquisition of participation in unlisted industry groups, their development and on-sale after a few years. However, in the last 15 years, such private equity providers also have established other business lines like credit funds, infrastructure funds, real estate funds or other alternative asset classes. Hence, the term private equity in a broader sense refers to all these business lines.

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The Merits of Luxembourg

The growth of private equity investments in Luxembourg is a consequence of several key advantages of Luxembourg compared to other jurisdictions.

Flexible company law and fund structures

Luxembourg offers a wide range of fund and company structures to the private equity industry. The flexible company and investment fund laws in Luxembourg allow private equity funds and investments to be structured in accordance with investors' needs. The most important fund structures (regulated and non-regulated) for private equity funds are:

- the specialised investment fund (SIF);
- the investment company in risk capital (SICAR); and
- the reserved alternative investment fund (RAIF).

All three fund types enable investment in different asset classes like private equity.

The SIF is the standard structure, authorised and supervised by the Luxembourg financial supervisory authority (Commission de Surveillance du Secteur Financier – CSSF) for private equity investments under the consideration of diversification rules.

The SICAR is the fund type especially intended to serve for private equity investments as it requires an investment in risk capital. It celebrates its 20th birthday in 2024. Its purpose is the collection of funds from well-informed investors who are aware of the risks and the development of the acquired target company. Risk diversification rules do not apply for SICARs.

The RAIF is similar to the SIF structure but is not authorised or supervised by the CSSF. This enables a simplified process and a shorter time to market in comparison with the SIF and SICAR. However, a RAIF needs to appoint a fully authorised AIFM for its supervision. Due to the swift and more cost-efficient launch, the RAIF is one of the preferred fund structure types for the set-up of AIFs since its introduction in 2016 and is also well-known by foreign fund promoters and investors.

The Luxembourg legislator regularly reviews the applicable provisions for fund structures and aims to adapt them to the current market situation. Therefore, in July 2023, the Luxembourg fund toolbox has been modernised by the law of 23 July 2023, eg, by lowering the minimum investment threshold for well-informed investors of RAIFs and SIFs to EUR100,000 (before EUR125,000) to allow an easier access to those fund products.

Limited partnerships and additional forms

In addition to the different AIF fund types, Luxembourg company law offers company forms that can be organised in accordance with the specific needs of the parties involved (general partners, limited partners, etc).

Private equity investors and managers have a strong preference for unregulated partnerships: the limited partnership (SCS) and the specialised limited partnership (SCSp). Both company types refer to the organisation of partners, with the general partner managing the company and, besides that, limited partners. The SCSp has no legal personality, is very popular and also attracts UK and US investors as it is similar to the English limited partnership. These company types are tax transparent and can be interesting for tax-exempted investors.

AIFs should be set up only in the form of an SCS or SCSp if not relying on the structure of a RAIF or a SIF. In this form, they are easier and more cost-efficient to set up for private equity fund structures, which have been preferred by private equity investors of late. They benefit from the flexible Luxembourg corporate law and can be set-up under private seal. If an SCS or SCSp shall have multiple compartments, the SCS and SCSp can also be structured as SIF or RAIF.

The SOPARFI (financial participation company), which is non-regulated (and also not a SIF or RAIF), is also used for the holding and financing of private equity investments. Such SOPARFIs usually take the form of a public limited liability company (SA), private limited liability company (SARL) or partnership limited by shares (SCA). These entities are fully taxable in Luxembourg, which is not the case for a SCS, SCSp, SIF or RAIF.

As a specific fund label, European long-term investment funds (ELTIFs) have been implemented in 2015. The more flexible ELTIF 2.0 framework, applicable since January 2024 has led to the result that Luxembourg ELTIF structures reflect around 70% of Europe's market share in ELTIFs. They create opportunities for retail investors to invest in alternative investment products like private equity.

Besides ELTIFs, also the EuVECA framework is interesting for venture capital/ private equity investments. The European venture capital funds Regulation (EU) no 345/2013 (EuVECA Regulation) provides harmonised requirements for qualified venture capital funds that intend to invest at least 70% of their aggregate capital contributions and uncalled committed capital in assets that are "qualifying investments" (EuVECA Funds).

Special purpose vehicles that are created and owned by the AIF and hold the target assets are also established in Luxembourg.

International and experienced staff

The Grand Duchy of Luxembourg has a population of around 660,000 residents, and an international environment where English has become the predominant working language in the financial industry. Investors and market players have a diverse choice of service providers with a strong expertise in private equity structuring, transaction advice, funds administration and depositary and audit services. Corporate documents and fund documentation can be prepared in English, German or French.

Other Luxembourg benefits

Another advantage is the European passport. Luxembourg AIFMs can manage Luxembourg funds as well as other AIFs established in other EU countries. This was utilised by UK companies prior to Brexit, with some fund managers, like M&G Investments, transferring their offices to Luxembourg in order to maintain the benefit of the European passporting regime. As mentioned in previous years, several large private equity firms have opened an office in Luxembourg, or even established their headquarters there. Their staff base has been increasing steadily over the last ten years. This was mostly followed by the moving of private equity funds to Luxembourg and/or the launching of new fund structures under Luxembourg fund types. 18 of the 20 largest private equity houses have operations in Luxembourg, and around two thirds of Luxembourg private equity firms also hold an AIFM licence in Luxembourg.

Luxembourg boasts a stable political and economic situation and keeps its Triple-A rating. Investors and firms also benefit from a flexible

and attractive tax regime that complies with EU regulations and directives.

Private Equity/Investment via Luxembourg Structures

Private equity target acquisitions are also carried out via Luxembourg structures. The advantage is that Luxembourg service providers are experienced in the structuring of private equity investments. The laws and the applicable tax regime can also be in favour of such transactions. Nowadays, market private equity firms prefer to have the entire private equity acquisition structure in Luxembourg to avoid the structures being distributed over several countries, and also to avoid European supervisory mechanisms taking effect.

Private equity investments in Luxembourg firms and by Luxembourg private equity firms

While many private equity firms that have moved to Luxembourg appreciate its attractiveness, it is also noteworthy that private equity investments into Luxembourg-based target groups or by private equity Luxembourg companies into other companies take place from time to time.

Despite the reduction in deal flow, major Luxembourg deals were noted

Apex Group, a global financial services provider, completed its acquisition of MJ Hudson's business outsourcing division in October 2023, enhancing its presence in Luxembourg. This acquisition integrated MJ Hudson's Luxembourg management company operations into Apex's existing FundRock brand, reinforcing FundRock's position as one of the largest management companies in Luxembourg.

In January 2024, it was announced that a global wealth management platform FNZ completed its acquisition of Luxembourg-based B2B fund platform Ifsam. The deal expands FNZ's capabilities in managing private equity and other alternative asset classes. FNZ further stated its plan to set up a centre of excellence for fund processing services in Luxembourg, supporting FNZ's significant investment in the European market.

Alter Domus, a leading global provider of end-to-end tech-enabled fund administration, private debt, and corporate services for the alternative investment industry, with headquarter in Luxembourg, announced in March 2024 that it has secured a new strategic investment from Cinven. Cinven is a leading international private equity firm focused on building world-class global and European companies. The transaction gives Alter Domus an enterprise value of EUR4.9 billion (USD5.3 billion).

Gen II Fund Services (Gen II), a New York-based private capital fund administrator, announced the acquisition of Crestbridge, a preeminent European provider of private capital fund administration solutions, in April 2024. The acquisition expands Gen II's presence in Luxembourg, increasing Gen II's assets under administration to over USD1 trillion.

Vistra Group has obtained regulatory approval to proceed with its acquisition of Kroll (Luxembourg) Management Company ("Kroll") in May 2024. Kroll will officially separate from its parent company in London by August 2024 and will then operate under the Vistra Luxembourg family of companies. A further merger with Vistra Fund Management is anticipated, pending subsequent regulatory approval.

The Luxembourg Future Fund 2 has announced an €8 million investment in the M80 Capital II CommV fund in June 2024, aimed at fostering digital transformation in small and medium-sized enterprises (SMEs). M80 Capital II CommV

focuses on leveraging advanced digital technologies such as IT management, robotics, the Internet of Things (IoT), and artificial intelligence (AI) to optimize business processes and enhance value creation for traditional SMEs facing complex challenges. This initiative strengthens Luxembourg's position in digital transformation. The LFF2 is joint initiative by the Luxembourg public-sector banking institution "Société nationale de crédit et d'investissement (SNCI)" and the European Investment Fund (EIF).

GAM, an independent investment manager listed in Switzerland, has announced in July 2024 it has reached a definitive agreement to transfer its Management Company activities in Ireland, Luxembourg and the UK to Apex Group.

It is noteworthy that Luxembourg-headquartered private equity company CVC Capital Partners successfully listed on Euronext Amsterdam in April 2024, raising EUR250 million and achieving a market capitalisation of EUR14 billion. Being the largest IPO in Europe for 2024, the IPO supports CVC's long-term growth and increases its profile, with the company managing approximately EUR186 billion in assets across various investment strategies.

Influence of the war in Ukraine and global conflicts

The war in Ukraine, further global conflicts that have arisen and the resulting inflation have impacted the international economic situation. The private equity market remained quite stable so far. The exposure of Luxembourg private equity asset managers to Russian assets has been very limited for a number of years.

Reporting requirements

Investor reporting can be considered an upcoming trend that is increasingly important in Luxembourg. As relevant data is requested by investors, transparency and daily reporting to investors becomes more important and needs to be considered by private equity market players in Luxembourg.

Growth of ESG importance

Reporting and investment need to take greater account of ESG criteria. Since Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (SFDR) became effective on 11 March 2021, investment fund managers and private equity firms have to consider ESG criteria when making investments. If they do not intend to consider such criteria, they need to explain their reasons and all related risks. Since 1 January 2023, the level 2 technical and formal guidelines (RTS) apply which provide for additional disclosure and reporting obligations for financial market participants. The European Supervisory Authorities published its proposed changes of the SFDR, amongst others, a new financial product classification system, in June 2024.

In addition, the EU's Corporate Sustainability Reporting Directive (CSRD) and European Sustainability Reporting Standards (ESRS) require the disclosure of sustainability information for large companies operating in the EU starting from the 2024 financial year, with the first reports due in 2025.

A growing number of investors are requiring the consideration of ESG criteria. Companies have become more accountable to shareholders and customers, and shareholders pay significantly more attention to how their money is invested and whether their investment has any positive or negative impact on the environment. For example, institutional investors like pension

funds focus on funds that promote or target sustainable investments (Articles 8 and 9 under the SFDR). This is a new challenge for private equity firms as there are more considerations to be taken into account when choosing an appropriate investment. Such firms need to review the impact and also the value of investments. 80% of private equity houses consider ESG to be a main topic for future investment and their marketing strategy.

Furthermore, banks are more frequently asking for ESG considerations when providing a loan facility. The attractiveness of investee companies could increasingly depend on the implementation of reliable and effective ESG policies and strategies by the target companies.

The SFDR, CSRD and other EU regulations that are expected to follow will become more and more important, and will influence private equity investments and investment funds in Luxembourg and elsewhere in the future.

Digitalisation and technology

Digitalisation and technology play a significant role in Luxembourg and represent potential investment opportunities but also a method used for private equity transactions. Private equity companies in Luxembourg now focus on technology-related companies, artificial intelligence (AI), machine learning, fintech, tokenisation and blockchain. According to a survey by S&P's 2024 Private Equity and Venture Capital Outlook, 54% of GP investment professionals expect AI to influence deal sourcing and target selection in the future. Luxembourg pioneered this trend with the establishment of the Luxembourg House of Financial Technology (LHoFT) early in 2017. LHoFT is the country's fintech centre, supporting the digital transformation of Luxembourg's financial sector by connecting financial institutions, investors, the IT industry and authorities.

Forecast

The Luxembourg private equity business is expected to grow continuously over the coming years, and to adapt to the upcoming regulatory and investor demands. As a well-known platform for private equity business, Luxembourg will develop with the market and support the growth of private investments in companies.

MALAYSIA

Law and Practice

Contributed by:
Munir Abdul Aziz, Ee Von Teo and Addy Herg
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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

Malaysia's diverse economy, robust policy framework, status as a significant commodity exporter and recently improved political stability have provided a strong foundation for a promising and steady economic recovery. This is partly reflected in a resilient M&A and private equity deal environment.

Private equity funds that are active in Malaysia generally adopt the following strategies.

- Focus on sectors that have the most exposure to growth trends in the broader economy, particularly the consumer retail industry. Specific examples of this trend include the acquisition of a significant minority stake by Creador, a Malaysia-based private equity firm, in Custom Food Ingredients, a local food industry supplier, in 2022. More recently, in 2023, Creador acquired a 40% stake in Pet World International, a Malaysia-based pet food manufacturer. Consumer spending accounts for a material percentage of Malaysia's gross domestic product (GDP) and is forecast to continue to grow as a result of the government's aim to increase labour's share of GDP to 45% under its overarching economic plan known as the Madani Economy framework.
- Focus on opportunities to unlock hidden value in listed and privately held conglomerates. Malaysia has historically had many conglomerates, both publicly and privately held as many businesses are founded and run by families. In recent times, Malaysian conglomerates have adopted a more proactive approach in portfolio management to realise greater value or to deleverage; a number of demergers, carve-outs or divestitures of non-core assets and businesses have followed. The Berjaya Corp group embarked on a three-year transformation plan in 2021 to streamline its businesses and reduce debt through the disposal of non-core assets. One of the group's listed entities, 7 Eleven Holdings, recently disposed of its interests in the Caring Pharmacy group to BIG Pharmacy Healthcare, a private group that includes Creador as one of its investors. Separately, IHH Healthcare monetised its investment in the International Medical University by disposing it to TPG's The Rise Fund, in order to redeploy its capital on its core hospital-related operations.
- Seek opportunities to create further value in target businesses that have been invested in by other private equity firms. Malaysia has also seen an increasing number of transactions between private equity firms. A recent example would be the acquisition by TPG's The Rise Fund along with co-investors Employees Provident Fund and Kumpulan Wang Persaraan (Diperbadankan) of a controlling stake in Asia Pacific University of Technology and Innovation (APU) from KV Asia Capital, a leading private equity fund focused on mid-market investments across Southeast Asia. KV Asia Capital had in turn acquired APU from Ekuinas, the Malaysian government-linked private equity firm. Each private equity investor in APU has created value in APU, and both Ekuinas and KV Asia have exited with enhanced valuations.
- Pursue consumer goods and retail opportunities in secondary cities and towns in Malaysia. Malaysia's continuing overall steady economic growth combined with a relatively young population with increasing amounts of disposable income has fuelled expansion in the consumer goods and retail sector, includ-

ing in secondary cities and towns in Malaysia. A number of private equity firms have been targeting businesses with a strong record of growth in outlets in Malaysia's secondary cities and towns. Good examples of these would be the household appliance retailer Mr DIY (in which Creador invested prior to its listing), Caring Pharmacy Group (acquired by Big Pharmacy, in which Creador is an investor), retail tea business Tealive (also invested in by Creador) and Al-Ikhsan Sports (in which Ekuinas is an investor).
- Seek to unlock value in digital transformation and leverage its close proximity to Singapore, a major regional data hub. Singapore's emergence as a major data hub and the scarcity of land and power in the city state, as well as the open investment policies of the Malaysian government, have sparked tremendous recent growth in the data centre industry, which in turn is fuelled by rapid global trends in digital transformation, including generative artificial intelligence and cloud computing. Data flows are critical to modern global business and Malaysia has an extremely strategic geographical location, which has also helped to make it a strong link in the global supply and service chain. One of the largest private equity transactions to have closed in 2023 was the acquisition from listed TMT group Time dotCom Bhd of AIMS Data Centre by the US infrastructure investor DigitalBridge Group, which has plans to develop it into the leading data centre in Asia. Private equity firms have also shown strong interest in acquiring stakes in data centres located in Malaysia, and the pattern is expected to grow further following the recent surge in data centre projects in Malaysia.
- Recently, private equity firms have been increasingly drawn to Malaysian infrastructure assets due to their stable revenue streams, scalability and growth prospects. Infrastructure assets and public service concessions are particularly attractive, offering opportunities for long-term returns. A prime example of a substantial private equity transaction in this space in 2024 involves Global Infrastructure Partners' involvement in a consortium alongside Malaysia's sovereign wealth fund *Khazanah Nasional Berhad*, Malaysian statutory pension fund Employees Provident Fund and Abu Dhabi's sovereign wealth fund ADIA to take private Malaysia Airports Holdings Berhad (MAHB). The proposed takeover is based on a total equity value of MYR18.4 billion (approximately USD3.93 billion).
- A likely future trend will be investments in the companies that provide services to facilitate the roll-out of the current administration's ambitious energy transition plan: the National Energy Transition Roadmap, which aims to increase the proportion of renewable energy supply to 70% of Malaysia's total capacity by 2050. Malaysia also recently lifted the ban on exports of renewable energy to capitalise on strong energy demand from neighbouring Singapore. UEM Group (wholly owned by Malaysian sovereign fund *Khazanah Nasional Bhd*) recently announced its collaboration with local and foreign investors to develop a 1 GW hybrid solar photovoltaic power plant that will be integrated with a renewable energy industrial park in Malaysia. There are also investment opportunities in connection with large-scale solar projects, third-party access to the national grid operated by *Tenaga Nasional Berhad* and corporate power purchase agreements.

1.2 Market Activity and Impact of Macro-Economic Factors

Key sectors of interest for private equity investment in Malaysia include the consumer goods

and retail sector, a broad sector that encompasses food and beverages, pharmacy and more specialised segments such as the pets retail market. This sector is favoured by private equity investors for a number of reasons, including favourable long-term prospects, driven by demographic trends, a growing middle class and rising incomes. These deals are also largely immune to commodity cycles and do not rely on government concessions. A number of deals in this sector were cited in **1.1 Private Equity Transactions and M&A Deals in General**.

Other sectors attracting strong interest from private equity firms include private education, healthcare, medical devices, producers of active ingredients in supplements and advanced manufacturing. There has also been increasing interest and investment in greenfield data centre development, specifically in the state of Johor.

The Johor-Singapore Special Economic Zone (JSSEZ) is expected to be a catalyst for private equity investment. By stimulating economic growth, attracting foreign investment, and creating new business opportunities, the JSSEZ is poised to expand deal flow, enhance exit options, and provide lucrative investment avenues in infrastructure, real estate, and human capital for private equity firms. Additionally, supportive government policies are likely to create a favourable investment climate in the region.

Geopolitical instability in the form of the global economic and political contest between the United States and China, the Russia–Ukraine war and conflict in the Middle East, has led to supply chain fragmentation worldwide, causing disruptions and escalating inflation. As a small and open trading nation with a population of 32 million, Malaysia is significantly exposed to these effects. Nonetheless, the broader macroeconomic outlook in South-East Asia has exhibited resilience, evidenced by the continued strong growth in the region's GDP.

Malaysia has benefitted from the "de-risking" strategy of many global multinationals that have sought to diversify their supply chains away from reliance on China by adopting a "China Plus One" strategy. Many elements of the supply chain of global multinationals have shifted to South-East Asia, including Malaysia. The Malaysian economy also rebounded relatively quickly after the COVID-19 pandemic, with strong fiscal support from the government resulting in strong trade and investment growth in 2022. It also has a relatively low rate of inflation, owing in part to extensive subsidies for essential goods.

While broader economic indicators provide grounds for optimism, the private equity landscape has not been immune to the dip in global deal activity seen in the first half of 2024. High interest rates, volatility in global economic conditions, a fraught geo-political environment and continuing uncertainty about the time scales over which returns from the digital and energy transitions may be realised have buffeted private equity sponsors. In Malaysia, additional risks have flowed from the susceptibility to adverse political or public reactions of certain investments made by foreign parties in industries considered to be of a sensitive nature. The impact of the war in Gaza has also significantly affected the performance of retail and consumer brands perceived to be sympathetic to Israel in Muslim-majority Malaysia.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Higher Labour Standards

Private equity firms looking to acquire interests in Malaysian companies should be mindful of the following significant changes in labour laws.

- The national minimum wage has been increased by 25% from MYR1,200 to MYR1,500 per month following the Minimum Wages Order 2022, effective from 1 May 2022.
- Under the Employment (Amendment) Act 2022, which came into effect on 1 January 2023, statutory protection is granted to all individuals entering into contracts of service, irrespective of wages. Examples of enhanced statutory rights of employees include the reduction of maximum working hours to 45 hours per week, increased paid maternity leave to 98 days and the introduction of seven days of paid paternity leave.
- However, employees earning more than MYR4,000 a month are exempted from certain protections, including the entitlement to overtime pay, termination benefits and retirement benefits.

Developments in Regulations Affecting Transactions

Reforms in listing rules will be made to improve the efficiency and speed of execution of the initial public offering (IPO) process. This will help facilitate exits by private equity firms from their investee companies.

A reduction of stamp duty rates from 0.15% to 0.1% of contract value, subject to a maximum cap of MYR1,000 per contract, for listed shares traded on Bursa Malaysia Securities took effect in July 2023. This will help reduce transaction costs and will be of benefit to private equity firms with significant investments in companies that seek to list, which are often required to hold a proportion of their shares in the listed company for a certain period under contractual lock-ups required by underwriters.

Further, a new capital gains tax (CGT) regime was introduced with effect from 1 January 2024. The CGT is imposed on gains or profits from the disposal of capital assets. The ambit of the disposal is wide ranging, and it will capture a variety of transactions involving the disposal of capital assets (including unlisted shares). The CGT rate applicable (i) for capital assets acquired before 1 January 2024, and disposed of on or after 1 January will be 10% on the chargeable income or 2% of gross on the disposal price; and (ii) for capital assets acquired on or after 1 January 2024, and disposed of thereafter will be 10% on the chargeable income.

ESG Disclosures

The Enhanced Sustainability Reporting Framework (ESRF) will come into force after 31 December 2023 through the Main Market Listing Requirements issued by Bursa Malaysia. The ESRF will require specific disclosure on sustainability matters, including areas such as total energy consumption and emissions management.

Of potentially greater interest to private equity firms is the recent publication of the Simplified ESG Disclosure Guide for small and medium scale enterprises, covering 15 topics across ESG matters. This may help facilitate investments in private Malaysian companies by private equity firms with an ESG focus.

The government has said that it intends to promulgate a national carbon policy, which will provide guidance on carbon trading at the state level.

Enabling Economic Policies by the Government

The government has released a wide-ranging economic policy document with multiple aims, including to:

- undertake structural reform of the Malaysian economy;
- transform the Malaysian economy by facilitating higher value and more complex economic activities;
- lift labour's share of GDP;
- enhance foreign direct investment; and
- foster a favourable environment for capital investment.

The Madani Economy framework sets out ambitious medium-term targets, such as for Malaysia to be ranked among the 30 largest economies in the world and to be ranked in the top 12 globally in the Global Competitiveness Index ranking within ten years. The framework aligns with the aims of the New Industrial Master Plan 2030, which is anticipated to envision a comprehensive strategy for the Malaysian economy to pivot towards high-value activities that enhance economic complexity.

There is a notable trend towards a more liberal outlook in relation to foreign direct investment policy. Recent major announcements of foreign direct investment are not linked to domestic equity participation. Tesla will be allowed full ownership of its proposed regional operations in Malaysia, and it has already started selling its vehicles online at competitive prices based on what appears to be favourable tax or duty treatment. Elon Musk's Starlink, which provides satellite communication services, has also been granted a ten-year Network Facility and Service Provider licence without being subject to the usual 49% foreign ownership limit.

The government is also trying to establish Malaysia as a data centre hub, and efforts have been made to lure Microsoft and Google to establish significant operations in the country. Amazon Web Services (AWS) has already announced its plan to open a cloud computing infrastructure facility and to invest MYR25.5 billion by 2037 to establish an AWS regional hub in Malaysia.

Malaysia has recently been achieving its highest levels of foreign direct investment in years, attracting MYR71.4 billion (approximately USD15.5 billion) in approved investments in the first quarter of 2023, representing an increase of 67% from the same period in the previous year.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Key Regulators Relevant to Private Equity Funds and Transactions

Fund management activities are regulated by the Securities Commission, and they require a capital markets service licence. For private transactions in the private equity space, the customary regulatory issues relevant to conventional/strategic acquisition will apply (please see further discussion below). As for public M&A or take-private transactions, private equity funds will need to comply with the takeover regime under the Malaysian Code on Take-Overs and Mergers 2016 (the "TO Code") and the Rules on Take-Overs, Mergers and Compulsory Acquisitions (the "TO Rules"), as administered by the

Securities Commission; where the target is to be delisted, they must comply with the delisting procedures and rules under the listing requirements administered by Bursa Malaysia.

Foreign Investment Restriction/Regime

There is no single overriding legislation or regulation, nor any single regulatory body that oversees or imposes foreign investment screening procedures or restrictions in Malaysia. The investment landscape in Malaysia is generally open to foreign investment, except in certain sectors and/or industries. Accordingly, foreign investment restrictions and/or requirements are generally sector-specific and are regulated through regulatory licences, registrations, approvals and/or permits issued or administered by the relevant sectoral regulators or governmental agencies.

Regulatory oversight over M&A activities in sectors where foreign investment restrictions apply is typically triggered by the following circumstances with respect to the M&A target holding the licence(s)/approval(s) issued by the regulators:

- direct and/or indirect majority share transfer;
- direct and/or indirect minority share transfer;
- asset/business transfer; or
- change of composition/control of the board of directors of the target.

Merger Control/Antitrust Filing

At present, there is no merger control regime for general M&A activities in Malaysia, except in specific industries (ie, the aviation service industry and the telecommunications industry). The regulator, the Malaysian Competition Commission (MyCC), is in the process of undertaking and completing public consultation on proposed amendments to the Malaysian Competition Act, to introduce and include a merger control regime, and to increase its own investigation and enforcement powers. The proposed amendments will need to be finalised and proposed to the Parliament (with MyCC indicating this is scheduled for some time in 2024); subject to the Parliament passing the proposed amendments, the merger control regime will come into effect, with a one-year transition period.

Approach to ESG Concerns

Whilst there is no statutory or regulatory requirement with respect to ESG from an M&A perspective, the constantly evolving and growing ESG issues and the exposure to regulatory, financial and reputational risks associated with ESG issues have an impact on the approach towards M&A activity (including the private equity space). ESG issues that might traditionally have been considered as transactional issues (from the compliance perspective, and given their financial impact on value) are now also considered for the reputational risks they pose in the near to long term. There has been increasing focus on the identification of ESG issues in due diligence, to enable private equity funds to assess the sustainability risks of their current portfolio and future investments.

4. Due Diligence

4.1 General Information

Generally, in-depth due diligence is carried out by private equity buyers/bidders. Depending on the sector in which the target operates, the typical due diligence areas that will be covered include financial, tax, legal, commercial, technical and compliance. The scope and materiality of the due diligence will be based on the buyer/investor's commercial assessment, financing requirements and risk appetite, taking into

account the nature and complexity of the transaction (as well as the target).

The key areas of focus for legal due diligence are typically:

- corporate information and ownership;
- regulatory approvals, licences and permits;
- material contracts;
- related party transactions;
- real property and/or assets;
- intellectual property rights;
- employment and labour disputes;
- material litigation; and
- financing and/or borrowings.

4.2 Vendor Due Diligence

Although there has been a growing trend for vendor due diligence in recent years, reliance on vendor due diligence reports is not common. Vendor due diligence has become increasingly common for auction processes implemented by private equity sellers to maintain a high level of competitiveness, with the goal of ensuring an organised and speedy process.

Notwithstanding the increasing trend towards vendor due diligence, bidders/investors typically still conduct their own due diligence and do not always accept vendor due diligence reports made available in the process. Typically, the vendor due diligence report will be provided on a non-reliance basis to the bidder/investor.

5. Structure of Transactions

5.1 Structure of the Acquisition

The acquisition structure is ultimately determined by the considerations and assessments of the private equity investor, which differ from case to case, having regard to the nature of the target and/or assets. As in other jurisdictions, the acquisition in Malaysia is largely structured as either a sale of shares or a sale of assets (or a combination of both).

For private target companies/assets, the acquisition is typically structured as a private treaty sale and purchase agreement. The process could be a bilateral transaction or an auction process. The terms of the acquisition do not deviate significantly by virtue of the transaction being negotiated through bilateral negotiation or through an auction process.

For public listed company/assets, the acquisition will typically be structured by way of general offers implemented pursuant to the TO Rules. In recent years, there has also been an increasing trend of adopting court-approved schemes within the scope allowed under the TO Rules.

5.2 Structure of the Buyer

It is not uncommon for the private equity fund to establish a holding company, which will in turn establish a special purpose vehicle/company as the acquisition entity. Depending on the mandate and strategy of the private equity fund, it is common for representatives of the private equity fund to be appointed as board members of the acquisition entity, who will in turn make key investment/operational decisions. Through this structure, the acquisition entity will be the contracting entity to the transaction document. The private equity fund is not the contracting entity whilst it is involved in the acquisition, but it may provide commitment to the seller (see **5.3 Funding Structure of Private Equity Transactions**).

5.3 Funding Structure of Private Equity Transactions

It is common for private equity funds to seek out conventional bank financing to support their

private equity deals. Depending on the structure and nature of the assets, the banks will work with the private equity investor to structure the leveraged finance transactions (and address financial assistance and/or debt push-down restrictions/limitations), and have generally shown willingness to support private equity deals on the basis that the banks passed their internal assessment of the target assets and also the sponsors and/or the private equity fund.

Equity commitment letters are common in Malaysia. In competitive auction processes in particular, the seller will also often request evidence of the availability of financing or debt financing.

5.4 Multiple Investors

It is common for a consortium to include and involve existing shareholders or management of the target/assets (see **7.1 Public-to-Private**) to further harness the value of the key operational know-how and experience of the owner/senior management of the target.

There are private equity deals involving a consortium of private equity sponsors (including such sponsors investing alongside other investors), but these are subject to the size and nature of the transaction where the transaction in question is of high value or complexity.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

The involvement of a private equity fund (whether as a seller or buyer) typically results in slightly more complex consideration mechanisms, such as purchase price adjustments (instead of a fixed price acquisition), and given that some acquisitions are financed through debt, which may be collateralised by the target's operations and assets, which are in turn subject to financial assistance restrictions in Malaysia.

The pricing structures of private equity transactions in Malaysia are typically based on locked-box or completion accounts. It is also not uncommon to see earn-outs used in transactions, to help retain and incentivise seller-managers who remain in the business for a fixed period of time post-completion.

6.2 Locked-Box Consideration Structures

To the extent that the parties have agreed to a fixed price locked-box consideration structure, interest is generally not charged on the fixed price. It is also not typical to charge interest on any leakage that may have occurred during the period between the locked-box date and the completion date.

6.3 Dispute Resolution for Consideration Structures

It is common to have a dedicated expert or bespoke dispute resolution mechanism to address any potential disagreement or uncertainties related to valuation, adjustments or performance metrics associated with the consideration structures, given the more complex valuation structures that are typically applied in private equity transactions.

The dedicated expert or dispute resolution mechanism applied will vary based on the type of consideration or valuation mechanics applied in the transaction, the specific terms of the transactions, the parties involved and the complexities that may be associated with the particular industry of the target.

6.4 Conditionality in Acquisition Documentation

As the regulatory framework in Malaysia imposes foreign equity restrictions and/or *Bumiputera* (generally refers to native or indigenous people of Malaysia) and local participation requirements, it is very common for conditions precedent to include the receipt of the necessary regulatory approval for the transfer of shares or change of control of a licensed target company. It is also not uncommon to see third-party consents of key customers/suppliers and shareholder approvals (due to the relevant thresholds set out in the Companies Act/Bursa Malaysia Listing Requirements being triggered) featured as conditions to completion in definitive transaction documents.

In addition, it is becoming increasingly common to have material adverse effect conditions in transactions in Malaysia, particularly where the buyer is a private equity fund.

6.5 "Hell or High Water" Undertakings

It is not common for private equity-backed buyers to accept "hell or high water" undertakings where they relate to regulatory conditions in Malaysia, given the prevalence of equity restrictions/requirements across various industries in Malaysia. Commitments to completing the acquisition and fulfilling regulatory conditions (if any) will need to be carefully negotiated in light of such challenges.

The specific carve-outs to "hell or high water" undertakings will vary based on the industry and the individual deal dynamics. To the extent that there is certainty regarding the lack of any equity restrictions or requirements, it is then not uncommon for buyers to demonstrate their commitment to completing the transaction by accepting such undertakings.

Where applicable, merger control and the new EU Foreign Subsidies Regulation regime may also feature in negotiations in respect of such undertakings. The inclusion or carve-out of such issues from the undertakings will require the necessary multi-jurisdictional merger control analysis to be carried out and an understanding of the type of subsidies or financial support that may have been received by the parties in question.

6.6 Break Fees

The concept of break fees is not common in Malaysia. Occasionally, a seller may request a break fee as part of an auction sale process letter, but it is typically dropped during the negotiation process.

6.7 Termination Rights in Acquisition Documentation

The circumstances under which a private equity party (whether as buyer or seller) can terminate an agreement will vary based on negotiation, legal requirements and individual deal dynamics.

Common termination events include:

- material adverse change events pegged to financials or the performance of the target company that have occurred prior to completion; and
- failure to fulfil the relevant conditions precedent, such as the receipt of the necessary regulatory approvals or completion of financing arrangements required by the purchaser within a specified timeframe.

The long-stop date for transactions varies based on the complexity of the transaction, the regulatory requirements involved and the types of conditions precedent agreed between the par-

ties. Long-stop dates must be tailored to suit the specific circumstances of each deal.

Where the transaction is complex and requires multiple third-party approvals, including regulatory approvals, the long-stop date might be as long as six months (if not more) from the date of signing of the agreement. Where the conditions precedent agreed between the parties are relatively limited and straightforward in nature, the long-stop date can be as short as one month.

6.8 Allocation of Risk

The allocation of risks in transactions differs when there is a private equity-backed buyer/seller involved compared to transactions without any private equity involvement. Deals involving a private equity buyer/seller will typically entail a more heavily negotiated set of transaction documents to address a robust set of deal terms, with more complex consideration structures with adjustments and earn-out features and risk allocation measures put in place.

In contrast, corporate buyers/sellers tend to focus on strategic synergies and operational integration, and they rely heavily on their industry knowledge and expertise. They may also be more familiar with the regulatory framework and dealing with the regulators in question, which will affect how the regulatory-related issues are dealt with during negotiations and the drafting of the definitive transaction documents.

6.9 Warranty and Indemnity Protection

W&I Insurance

Where there is a private equity-backed seller involved, a “sell-side flip” warranty and indemnity insurance process is often applied. The private equity-backed seller’s W&I insurance broker will provide indicative terms for the policy at the commencement of the sale process, with the intention for the insurance policy to be ultimately purchased in the name of the buyer.

To the extent that the management team is also exiting and is involved as part of the sale process, they will not typically be made to provide additional or separate warranties or indemnities to a buyer. The sale of their shares is typically stapled to the exit of the private equity-backed seller, and they will provide the same set of warranties and indemnities, which shall in turn be insured by the same warranty and indemnity insurance package.

The limits on liability will depend on the W&I policy ultimately purchased. The common limit for title and capacity warranties is 100% of the purchase price, and the business and operational-related warranties are capped in the range of 20% to 50% of the purchase price.

Limitations on liability are typically applicable only to warranties, but sellers with a strong bargaining position (such as in auction processes) will ask for the cap to apply to the whole sale agreement. It is also common to carve out fraud from the limitations on the seller’s liability in Malaysian M&A deals.

The time limit of the seller’s liability (other than tax) is generally 18–24 months after completion, which is tied to one or two audit cycles of the target company. The seller’s tax liability typically lasts for up to seven years post-completion, which ties to the tax audit statutory limitation period in Malaysia.

6.10 Other Protections in Acquisition Documentation

Deposits, escrows, retention and the holding back of the purchase price are not common

features in Malaysia. They may be requested by local counterparts but are typically pushed back.

The use of warranty and indemnity insurance is common in private equity deals, especially where the private equity fund is the seller.

6.11 Commonly Litigated Provisions

Litigation in private equity-backed transactions can occur, but it is not common in Malaysia. The following terms may potentially lead to litigation:

- purchase price adjustments – disagreements on adjustment mechanisms such as how performance is measured or whether targets have been met for purposes of the earnout-related calculation or net asset value or working capital related adjustments;
- breach of warranties – discovery of inaccurate, misleading or breached warranties;
- indemnification claims – disputes as to whether the claims are valid and the extent of the coverage of the indemnification; and
- fraud or misrepresentation claims – allegations of fraud or intentional misrepresentation.

7. Takeovers

7.1 Public-to-Private

Public-to-private transactions involving private equity-backed bidders are common and are often undertaken through a combination of private equity investors and existing shareholder(s) and/or management. The target company (and its board) will be subject to announcement obligations in the takeover process. The legal regime also imposes rigorous rules against insider trading and market abuse, and the relationship and/or communication between the bidder and target (and/or the management) must be carefully managed. Therefore, thorough and rigorous planning for such transaction and the takeover process is fundamental to address the regulatory hurdles and restrictions.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

The material shareholding disclosure obligation rests on a substantial shareholder holding 5% or more interest in shares in the public listed entities. The substantial shareholder is required to give notice to the listed entity of:

- its interest in shares in the listed entity;
- any change in the percentage/level of such interest; or
- where it ceases to be a substantial shareholder.

7.3 Mandatory Offer Thresholds

Pursuant to the Malaysian Capital Markets and Services Act 2007 and the TO Rules, the applicable thresholds for triggering a mandatory general offer are as follows:

- where the offeror, including persons acting in concert (PAC) with the offeror, acquires, holds or exercises control of more than 33% of the target company's voting shares; or
- where the offeror (together with PAC) already hold between 33% and 50% of the target company's voting shares and subsequently acquires more than 2% of the target company's voting shares in any six-month period.

As the concept of PAC is very broad under the TO Rules, private equity-backed bidders will need to consider the arrangements between the funds/portfolio companies; and determine whether any entity/persons will be considered PAC for the purpose of the transaction in question.

7.4 Consideration

For a mandatory general offer (ie, where the obligation to make the general offer by the acquirer is triggered as the acquirer is entitled to exercise control or meets the takeover threshold), the offeror must provide a wholly cash consideration, or another consideration accompanied by a wholly cash alternative.

For a voluntary general offer (where an offer is made voluntarily and simultaneously to all the shareholders of the target to acquire the shares of the target), an offeror is required to provide a wholly cash consideration as an alternative in the following circumstances:

- where 10% or more of the voting shares of the target have been purchased for cash by the offeror and PAC during the offer period and within the six-month period before the beginning of the offer period; or
- where the Securities Commission determines that it is necessary to give effect to the requirement under the TO Code.

7.5 Conditions in Takeovers

For a mandatory general offer, no conditions can be attached, other than the condition that the offer is subject to the offeror having received acceptances that would result in the offeror (and its PAC) holding in aggregate more than 50% of the target's voting shares.

For a voluntary general offer, an offeror is required to make the offer conditional upon the offeror receiving acceptances that result in the offeror holding an aggregate of more than 50% of the target's voting shares. No condition can be imposed that is dependent on either an event that is within the control or is a direct result of the offeror's action, or the subjective interpretation or judgement of the offeror. For instance, financing conditions would not be permitted, as the offeror must have adequate financial resources to fulfil the offer obligation and offer the fully cash option.

Other deal security measures such as exclusivity arrangements are not uncommon and can be included subject to the TO Rules. Break fees are not commonly included, as they give rise to risks of providing financial assistance in connection with the purchase of the target's shares.

7.6 Acquiring Less Than 100%

After a takeover offer has been made, the offeror can seek to compulsorily purchase the shares from the remaining minority shareholders of the target if the offeror acquires 90% of the nominal value of the shares in the target company. A minority shareholder can also require the offeror to acquire its shares under the terms of the takeover if the offer has been accepted by the holders of at least 90% in value of the shares in the target company, and the offer period has not expired.

7.7 Irrevocable Commitments

Seeking arrangements with the existing shareholders/principal shareholders by way of an irrevocable undertaking to sell the shares in the target is not uncommon in Malaysia. The offeror will seek irrevocable undertakings from principal shareholders to accept the offer or to vote in favour of accepting the offer.

Such irrevocable undertakings are typically sought during negotiation and given prior to the launch/issue of the offer by the offeror. The nature or scope of the commitment in these undertakings varies, depending on the offer terms. Where the offer terms are favourable, it is not uncommon for the offeror to not allow any

"out" for the principal shareholder if a better offer is made.

The offeror (and the principal shareholders) will need to be cautious of the arrangements amongst them with respect to the giving of irrevocable commitments and the terms contained therein, in view of the TO Rules and the restrictions (for instance, to not give rise to a "favourable deal").

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Generally, incentive plans for management are structured on a long-term basis. However, short-term incentives based on annual results are also sometimes implemented.

The level of equity ownership granted to a management team in a private equity transaction will vary based on the size of the portfolio company, the industry, the role of the management team, the private equity fund's strategy and negotiation between the parties. In general, the management team will typically receive a minority equity stake in the range of 5–10%. The stake might increase depending on the achievement of specific financial or performance targets of the portfolio company over time.

8.2 Management Participation

In private equity transactions, management participation can be structured using various mechanisms, including "sweet equity" and "institutional/equity strip".

Sweet Equity and Institutional Strip

Sweet equity often involves the granting of a portion of equity ownership to key managers as a form of incentive or reward: the granting of equity ownership in the portfolio company is typically done in the form of shares, options or units of ownership at a favourable price. This will align the interest of the individual key managers with the success and financial performance of the company.

Institutional/equity strip involves the selling of a portion of the equity ownership in the portfolio company to external investors while still retaining control. This allows the key managers to participate in the equity ownership alongside the private equity fund. The amount of equity ownership sold to external investors is typically a minority stake that would not affect the private equity fund's control of the company.

8.3 Vesting/Leaver Provisions

Leaver provisions relate to the treatment of the equity incentive plans granted to key executives or management personnel if they leave the company.

The leaver provisions will typically deal with the following issues and concepts, amongst others.

- Good leaver/bad leaver – good leavers are individuals who leave the company on good terms, such as through resignation, retirement, death or disability. In contrast, bad leavers will be individuals who are terminated for cause.
- Vesting – unvested shares are typically forfeited by management shareholders upon their departure from the company, especially if they are bad leavers. Vesting schedules might also be accelerated for certain types of good leavers, allowing them to retain more shares to the extent that they have helped the company to hit or surpass the relevant targets set prior to a pre-determined deadline.

- Forfeiture – the forfeiture of vested shares is typically done at a discounted price for bad leavers, whilst good leavers will be entitled to receive the full fair market value of their shares.

8.4 Restrictions on Manager Shareholders

Restrictive Covenants

Restrictive covenants such as non-compete and non-solicitation of employee provisions are fairly common and are typically imposed on management shareholders. Such provisions are usually featured in shareholders' agreements and/or employment agreements. However, post-termination non-compete provisions (ie, after the management shareholder has exited the portfolio company via the sale of their shares in the company and resignation from their executive role in the company) are generally not enforceable in Malaysia.

8.5 Minority Protection for Manager Shareholders

Minority protection for manager shareholders involves implementing mechanisms to safeguard their rights and interests.

Given that the equity stake typically granted to management shareholders is relatively minimal, the minority protection rights granted are typically relatively limited and will vary depending on the company's structure, the agreements already in place, the importance of the role of these managers in the company and the amount of equity held by these individuals.

Terms such as the following will be built into the shareholder's agreement entered into between the parties:

- board representation or executive role in the portfolio company;
- a short list of reserved matters and veto rights;
- anti-dilution protections;
- information rights; and
- exit rights such as drag-along/tag-along rights.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

The private equity fund shareholder usually has representation on the board of the company if it wishes to have a say in the management and direction of the company. Representation on the board may also include a presence on the audit and compensation committees.

A shareholders' agreement or the constitution of a target company will entrench the private equity fund's right to appoint a majority of members to the board for private limited companies.

The private equity fund may also create particular corporate governance and approval authority workflows to impose restrictions on management undertaking any fundamental matters (such as a major acquisition or disposal) or large projects without board approval.

9.2 Shareholder Liability

A key principle of the common law system is that the liability of a shareholder in a limited company is restricted to the value of the shareholder's investment. As such, the private equity fund will not be held liable for the actions of its portfolio, except under very limited circumstances.

The courts' ability to override that principle and pierce the corporate veil to impose liability on a private equity fund shareholder is limited to where there is an element of fraud involved.

10. Exits

10.1 Types of Exit

Exits

The common forms of exit for private equity funds in Malaysia are via IPOs or trade sales to strategic investors or to another private equity firm.

Dual-track exits are not common in Malaysia. The Malaysian securities regulator would raise queries and be likely to refuse to process the IPO application if there is also an intention or an ongoing process for an outright sale of the same company.

Rollover/Reinvest

Whether private equity sellers would choose to do the following upon exit would depend on several factors, including the private equity fund's objectives, the investment opportunities available and market conditions.

- Rollover – private equity sellers reinvest a portion of the proceeds from the sale of the portfolio company into the acquiring entity or new structure that emerges after the exit. This will align the private equity seller's interests with those of the new buyer, which may be a strategic buyer or another private equity fund.
- Reinvest – private equity sellers invest their proceeds from the sale in other opportunities as part of the diversification of their investment portfolio, and reduce concentration risk by investing in different industries and asset classes.

The private equity fund seller may choose a combination of both, reinvesting a portion while diversifying and investing elsewhere.

10.2 Drag and Tag Rights

Drag and tag rights are fairly common in transactions involving private equity funds. The inclusion and specific terms of these rights will vary from one private equity deal to another, depending on negotiations and the unique circumstances of the investment, such as the equity restrictions applicable, the shareholding held by the relevant joint venture partners and the bargaining power of the parties involved.

10.3 IPO

Lock-up arrangements are common to restrict shareholders – including private equity sellers (who may be majority stakeholders) – from selling their shares for a specified period after the IPO. The typical lock-up period for private equity sellers varies but it is often approximately 180 days from the IPO date.

Lock-up arrangements are typically set out in the underwriting agreement entered into between the portfolio company and the underwriters managing the IPO process. The specific terms relating to the lock-up arrangements will depend on the terms negotiated between the private equity seller, the company and the underwriters.

Trends and Developments

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Wong & Partners is an award-winning, full-service law firm and a member firm of Baker McKenzie International. With 24 partners and over 50 associates, it is well equipped to assist across a comprehensive range of legal matters, including M&A, competition law, dispute resolution, equity and debt capital markets, employment law, joint ventures, tax and real estate law. It regularly acts for clients looking to conduct complex inbound and outbound investments, as well as foreign direct investments into the country. The firm's clients include some of the most respected multinational and domestic corporations across various highly regulated industries, including financial services, consumer goods, industrial manufacturing, technology, media and telecommunications. Wong & Partners is ranked in Band 1 by Chambers & Partners across seven practices.

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Private Equity Trends in Malaysia – An Overview

Stabilising macroeconomic factors in 2024 have contributed to an uptick in private equity/financial sponsor deals in South-East Asia (SEA). Based on EY's Quarterly PE Update: ASEAN 2Q2024 report, for the second quarter of 2024, there were 28 deals worth USD5.6 billion deployed across SEA, up from the 17 deals worth USD586 million in the quarter before. The report finds that Singapore and Malaysia contributed to the majority of deals, representing some 92% of total PE value and 57% of PE deal volume in Q2 of 2024.

In Malaysia in particular, the government's continued push to attract foreign direct investment (FDI) and the expansion of the venture capital ecosystem has sparked a surge in local fundraising as evidenced by the wave of announcements and commitments that followed the inaugural KL20 Summit. This includes the announcement of a new national fund-of-funds by *Khazanah Nasional*, which will invest MYR1 billion of its inaugural funds in high-growth Malaysian businesses and Malaysia's Retirement Fund Inc's (KWAP)'s new initiative, *Dana Pemacu* with an allocation of MYR6 billion to create up to 12 funds in the PE, infrastructure and real estate classes.

In contrast to acquisitions, exit activity has moved at a slower pace in the first two quarters of 2024 and this is a trend which is likely to continue into 2025, largely because of market uncertainty and domestic pressures such as the weakened ringgit. This will likely lead to an increase in secondary transactions and continuation funds as financial sponsors hold out for more favourable market conditions and better returns.

2024 deal activity and exits

Despite the global and regional slowdown in deal volume in 2023, private equity activity in Malaysia remained robust, with recent large-cap deals such as:

- the USD1.3 billion acquisition of Ramsay Sime Darby Healthcare by TPG-backed Columbia Asia Healthcare;
- KKR's USD400 million investment into OMS Group, a Malaysian subsea cable installer; and
- Global Infrastructure Partners' announced conditional acquisition of Malaysia Airports Holding for USD3.1 billion.

Momentum in mid-market private equity activity (the traditional mainstay of private equity investments in Malaysia) remains consistent, primarily in the consumer, healthcare and industrial sectors, setting the stage for a promising second half of 2024.

Gestating exits during the pandemic and an increase in strategic divestitures by corporates will also likely increase the number of exits and secondary transactions in the Malaysian private equity space in the next 12 months. Upcoming processes involving infrastructure, healthcare and industrial assets have already been launched and are expected to close in the last quarter of 2024.

Recent key trends

Data centre boom

Private funding for data centres has flooded the market, with global private equity-backed data centre deals accounting for 90% of all deals in 2023. Malaysia has emerged as a hub for data centres in SEA in recent years and private equity investment is rapidly increasing, as illustrated by:

- Digital Bridge's recent acquisition of data centre firm AIMS Group (valuing AIMS at MYR3.2 billion) from TIMEdotCom;
- Gaw Capital Partners' investment in Cyberjaya (under its Infinaxis Data Centre platform); and
- the acquisition of two data centres from *Permodalan Nasional Berhad* by Bridge Data Centres (a Bain Capital portfolio company).

Land acquisition costs, energy and sustainability remain the key considerations for investors. In an effort to address some of these concerns, national energy provider *Tenaga Nasional Berhad* recently launched the Green Lane Pathway to streamline the on-boarding process for data centres, expedite approvals and facilitate a smooth set-up of data centre operations in Malaysia. The Malaysian government is also currently focusing on digitalisation initiatives and the launch of "industry 4.0" blueprint investments, which is set to accelerate demand for data centres in the country. Recent investments have been concentrated in Cyberjaya and the southern state of Johor.

Energy transition

According to Bain's SEA Green Economy 2024 Report, corporates, private equity/venture capital, infrastructure funds, green funds, sovereign wealth funds and government-affiliated companies invested approximately USD6.3 billion in green investments into SEA in 2023. In Malaysia, there has been a 326% increase in private green investments in 2023 of USD1.03 billion accounting for approximately 15% of the 2023 SEA total due to an increase in large-scale deals specifically in the building sector. Within that, private equity investors are increasingly turning their attention to renewables and raising dedicated funds with longer term investment horizons focusing solely on renewable energy in recognition of the scaling opportunities in the region.

Under the Malaysian National Energy Transition Roadmap (NETR), the Malaysian government aims to develop future capabilities and to shape demand in the green energy market, by providing ten flagship catalyst projects based on six energy transition levers:

- energy efficiency;
- renewable energy;
- hydrogen;
- bioenergy;
- green mobility; and
- carbon capture, utilisation and storage.

Flagship catalyst projects include the development of a pilot renewable energy zone by sovereign wealth fund *Khazanah Nasional Berhad*, which will include the establishment of an industrial park, a zero-carbon city, a residential development and a data centre. On the back of the launch of the NETR, I Squared Capital (through its portfolio company HEXA Renewables) has also announced its commitment to develop up to 1 GW of hybrid solar photovoltaic projects in the southern tip of Peninsular Malaysia.

Medical tourism

The medical tourism industry has seen an explosion in growth, attributable to Malaysia's lower cost of medical services compared to developed nations. The sector has been identified as one of the nation's key economic areas for development. As of 2023, the contribution to national revenue from medical tourism was MYR2.23 billion, with a potential growth value of up to MYR2 billion by 2025.

The Malaysian government also continues to roll out initiatives to promote and support the medical

tourism industry, such as its recently launched first Flagship Medical Tourism Hospital Programme, which provides selected hospitals with certain incentives, including investment tax allowances. Amongst the four shortlisted candidates for the Flagship Medical Tourism Hospital Programme, two hospitals are private equity-backed (Island Hospital and Mahkota Medical Centre).

New legal considerations for private equity deals in 2024

FDI regulation

No overriding legislation, policy or regulatory body imposes restrictions on foreign investment in Malaysia. Instead, FDI restrictions are imposed on a sectoral basis, by the relevant industry regulator through the grant and administration of licences, permits or other governmental approvals, or as a condition to qualify for any government-related tenders or concessions.

The following key industries are or may be subject to FDI restrictions in the future.

- *Healthcare* – demand for private healthcare in Malaysia is driven by an ageing population, increasing life expectancy, an increase in non-communicable diseases, changes in technology and an expanding middle class, making it one of the most resilient industries even in periods of uncertainty. Existing private equity involvement in the healthcare industry in Malaysia is significant, with recent notable investments into Straits Orthopaedics, Columbia Asia and Sunway Healthcare. Apart from the services sector, there is also increasing interest in sub-sectors such as life sciences, medical devices, pharma/biotech and medtech. While the sector is largely liberalised, it should be noted that the Malaysian Ministry of Health is currently formulating formal guidelines to regulate foreign participation in the private healthcare sector, and new equity caps may be imposed in certain sub-sectors of the private healthcare sector.
- *Education* – investment activity in Malaysian private education has surged, primarily in K-12 education and specialised tertiary institutions. The trend will likely continue unabated, given the national growth in student population and increasing consumer preference for private education. Recent notable private equity investments in this sector include investments into Asia Pacific University and Asia Pacific Institute of Information Technology, International Medical University and International Medical College and Taylor's Education Group. Investments in the sector continue to be subject to foreign investment restrictions, with caps on foreign participation in certain segments of the industry, such as K-12 national curriculum schools, private colleges, language centres and kindergartens.
- *Consumer and retail* – notwithstanding subdued consumer sentiment from inflationary pressures and the weaker Ringgit, deal flow in retail and consumer-focused deals remains consistent, driven by demographic characteristics such as the burgeoning middle class and rising disposal household incomes. Relatively smaller deal sizes, competition for quality targets and continued foreign investment restrictions are expected to remain key challenges for foreign private equity entities looking to gain a foothold in this sector. Recent notable transactions include the acquisitions of premium retailer Jaya Grocer and hypermarket operator TF-Valuemart.

Foreign participation in the sector remains subject to equity and operational restrictions, as set out in the Guidelines on Foreign Participation in Distributive Trade Services in Malaysia 2020

issued by the Ministry of Domestic Trade and Cost of Living.

Introduction of merger control filings

The Malaysian Competition Commission (MyCC) is seeking to introduce a new cross-sector mandatory merger control regime, which will prohibit mergers that may result in a substantial lessening of competition. At present, Malaysia is the only country in ASEAN that does not yet have a merger control regime. The legislative amendments are expected to be debated in Parliament by the end of 2024, and will come into effect after a one-year grace period.

The proposed notification regime is a hybrid of mandatory and voluntary notifications (ie, notification is mandatory if the anticipated merger exceeds the prescribed thresholds but enterprises can also voluntarily notify MyCC when the prescribed thresholds have not been exceeded). The notification threshold has not been published.

Deal timelines for future private equity deals across all sectors will need to take into account the potential timeline for MyCC to process a merger notification, which could take between 40 and 120 working days.

Introduction of capital gains tax on the disposal of unlisted companies

A new capital gains tax (CGT) regime was introduced from 1 January 2024 on any gains or profits from the disposal of a capital asset situated in Malaysia, which includes the disposal of unlisted shares of a Malaysian company or the shares of a controlled company incorporated outside of Malaysia where more than 75% of the value of the foreign company's total tangible assets are comprised of real property situated in Malaysia or shares of another controlled company. The CGT rate for capital assets acquired prior to 1 January 2024 is either 10% of the chargeable income from the disposal of the capital asset or 2% of the gross on the disposal price of the capital asset. For capital assets acquired after 1 January 2024, the CGT rate is 10% of the chargeable income from the disposal of the capital asset.

ESG considerations

ESG considerations are becoming more prevalent in Malaysian deals, especially private equity-backed deals. This is driven by limited partners imposing heightened requirements on private equity funds in this area (such as pension and sovereign wealth funds, which are increasingly concerned about the system-level effects of climate change and inequality).

This is altering the manner in which due diligence needs to be conducted for private equity deals and poses a challenge in Malaysia for deals involving privately held companies (such as SMEs), as meaningful ESG due diligence by private equity investors often cannot be conducted easily in Malaysia due to limitations on data collection by the target. This issue will only continue to compound as substantive ESG and ESG reporting requirements imposed by investors become more stringent and sophisticated.

In response to growing demand by investors, Bursa Malaysia in collaboration with the London Stock Exchange has taken the first steps to creating a Centralised Sustainability Intelligence Platform (CSI Platform), which is a centralised repository for ESG disclosures to enable Malaysian companies to consolidate and disclose ESG data in a standardised manner. The CSI Platform is aimed at listed companies but will be open to all Malaysian companies (including private companies), and Bursa Malaysia is encouraging both public and private companies to participate by leveraging on ESG digital tools.

MEXICO

Law and Practice

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

So far, 2024 has been a good year for private equity transactions generally, and for certain sectors specifically. There has been an increase in both the number of transactions, as well as their size. The increase is a consequence of certain funds' exits, mainly due to the lapse of time of their initial investment, and other funds taking on opportunities that result from a stable economy and emerging sectors. Some of the sectors that have seen more activity are technology, healthcare and consumer goods, due to the rise of e-commerce and fintech, and the fact that M&A activity is driven by the pursuit of operational efficiencies and the expansion of service offerings, given that, investors are generally looking for digital solutions and long-term sustainable practices.

Other relevant trends include a tighter and stricter approach to valuation. With the increase in interest rates and money being more expensive, funds are looking harder and with a higher degree of scrutiny at new investments. Additionally, Mexico has always benefited from its geopolitical position next to the United States, generally allowing for a continuous increase in cross-border economic activity and, thus, an ongoing trend for private equity transactions – nowadays, specifically, in respect of real estate transactions resulting from the nearshoring phenomenon. Albeit at a minor level, European and Middle Eastern private equity funds are increasingly looking into a variety of investment opportunities in Mexico. Finally, private equity funds seem to be focusing on versatile businesses that can adapt to any fast-changing industries and environments and that strive to apply principles of sustainability.

1.2 Market Activity and Impact of Macro-Economic Factors

As discussed above, in Mexico in 2024, the sectors where private equity has been more active are:

- technology – as a result of the constant search for digital solutions and innovation;
- healthcare – due to the growing demand for healthcare services and recent reforms in Mexico's healthcare system, including changes to public and private healthcare regulations; and
- consumer goods – partly as a consequence of the backend of the recovery from the pandemic.

Also as discussed before, higher interest rates and money being more expensive result in higher financing costs for private equity funds, which translate into more detailed, stricter assessment of potential targets and investments. To try to avoid minimising or limiting the size of the investment from a cash perspective, private equity funds try to find creative ways to structure transactions, including by negotiating earn-outs and other performance-based incentives.

Macroeconomic conditions, such as inflation and the volatile Mexican peso/US dollar exchange rate, have also contributed to private equity funds adopting a more cautious approach when evaluating investments and taking a harder look at opportunities. Another factor driving the cautious approach is geopolitical events. Both the United States and Mexico are in the midst of contentious and high-profile presidential elections and changes in government, creating uncertainty as to how the new presidents in each country will handle foreign investment control, monetary policy and other regulatory

matters, resulting in a cautious approach to new transactions.

While these represent challenges for new investments, private equity activity in Mexico has continued to increase.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Mexico has passed several reforms over recent years, including changes to the prior energy reform, labour laws, tax laws and an increased regulatory framework in respect of anti-money laundering, counter-terrorism financing and data privacy protection laws. As a result of these reforms, when evaluating and negotiating investments, private equity funds have to conduct a more expansive and extensive due diligence process to account for deliverables, third-party consents (including from certain government authorities) and potential contingencies deriving from foregoing changes in the law. As these relate to private equity portfolio companies, many of these changes in the law require each entity to incorporate new internal and external policies (ie, anti-money laundering policies, ESG programmes and data privacy notices) and, in certain cases, such as in respect of labour reform, to conduct internal restructurings (ie, employee hire schemes).

Furthermore, the transition made in 2020, by replacing the North American Free Trade Agreement (NAFTA) with the United States-Mexico-Canada Agreement (USMCA), continues to impact the economy, increasing opportunities, growth, and business prospects.

In conducting transactions, certain consent requirements or pre-closing remedial actions can be time-consuming and extend the negotiation process, thus increasing the cost, both from a time and fees perspective.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Key Regulators

Prior to engaging in any M&A transaction, the parties must evaluate whether any government approvals are required, specifically, the approval of the Federal Antitrust Commission (*Comisión Federal de Competencia Económica* – COFECE) or the National Commission of Foreign Investment (*Comisión Nacional de Inversiones Extranjeras* – CNIE). In addition to the foregoing, there are instances where authorisation from the Ministry of Economy (*Secretaría de Hacienda y Crédito Público* – SHCP) or the Mexican Securities and Exchange Commission (*Comisión Nacional Bancaria y de Valores* – CNBV) is required. Additional authorisations could be required, but these are more specific to a particular transaction in a specialised sector – for example, authorisation by the Ministry of Infrastructure, Communications and Transportation (*Secretaría de Infraestructura, Comunicaciones y Transportes* – SICT) in respect of telecommunications transactions.

In respect of COFECE approval, this would be required if the transaction and/or the agents involved (including the private equity fund, directly and indirectly) satisfy one of three statutory thresholds, these being the value of the transaction, the assets of either one of the agents in Mexico, and the combined assets of all agents involved. Also, COFECE has issued non-binding guidelines in respect of non-compete arrange-

ments which it could also use to comment on a transaction. Provisions regarding the filing with COFECE and the ability of the parties to exit a transaction based on conditions imposed by COFECE are heavily negotiated.

As it relates to foreign investment controls, the notice or consent requirement varies depending on the industry where the direct or indirect investment is being conducted and the percentage of the investment (ie, there are activities that are reserved exclusively for Mexican nationals, or entities 100% controlled by Mexican investment, and others for which the percentage that foreign investment may hold is limited). In recent years, foreign investment controls have become stricter, specifically in more sensitive sectors (ie, aerial passenger and cargo transportation) in an effort to protect national interests and sovereignty.

National Security

In respect of national security, scrutiny comes through the diverse government agencies whose consent is required, namely the National Commission of Foreign Investment (CNIE). While foreign investment is not a specific national security matter, scrutiny of a foreign national would start with this organism. It is important to note that while the law does not necessarily differentiate between private foreign investment and state-backed investment, the latter naturally undergoes a higher degree of scrutiny.

EU FSR Regime

The EU FSR Regime is not really applicable in Mexico. This regime could be related to a transaction in Mexico to the extent that a private equity fund from a European jurisdiction is participating. Here, the burden would be on such participant to comply with the additional scrutiny in Europe. At this point, this is not likely to be of material relevance to the private equity sector in Mexico.

Anti-bribery, ESG – Recent Developments

While not a specific development, over the last 12 months more anti-bribery investigations have been conducted and it appears that the related laws are being and will be more strictly applied and enforced. This, in addition to the more comprehensive due diligence process, is resulting in private equity portfolio companies having to implement and enforce harsher and stricter compliance policies, as well as compliance by all members of the company.

ESG is a trending topic worldwide and Mexico is no exception. Both government authorities and the market in general are scrutinising investments, issuances and day-to-day operations to consider ESG practices. Private equity is no exception to the foregoing, and investments are being scrutinised to ensure that they include an ESG component.

4. Due Diligence

4.1 General Information

Generally, investors ask for a full and extensive due diligence review with a view to producing a red flag report (ie, highlighting key findings in respect of items requiring either some action or special consideration and identified contingencies). However, there are instances where investors require a full due diligence report which includes full descriptions of all legal aspects of a target company, including templates identifying the main provisions of diverse legal documents executed by the target.

Due diligence is not limited to reviewing documents. It comprises other activities, such as

available public independent searches (ie, public registries), site visits, management presentations conducted by the target, and Q&A processes with relevant officers of the target.

As mentioned before, a legal due diligence is a comprehensive process as it focuses on all relevant areas; however, focus and detailed review may vary based on the industry and operations conducted by the target.

Key Areas Covered by Standard Legal Due Diligence

The following are the key areas covered by a standard legal due diligence in Mexico:

- corporate;
- material agreements;
- real estate matters;
- financing matters;
- environmental and other regulatory matters;
- labour and employment matters;
- intellectual property;
- compliance (including anti-bribery and anti-money laundering);
- litigation;
- tax matters;
- data privacy; and
- insurance.

Additionally, in Mexico, the use of representations and warranties (R&W) insurance is less common than in other jurisdictions. While some players are currently making an effort to implement it, the number of exceptions and exclusions for Mexico result in lower use of the product. Consequently, the legal due diligence report becomes not only a key element for understanding the target's business and deciding whether to move forward with the proposed transaction, but also plays a fundamental role in negotiating the underlying M&A agreement. This is particularly relevant with respect to representations and warranties, and indemnification clauses.

4.2 Vendor Due Diligence

Vendor due diligence has proved to be a valuable resource for conducting due diligence processes in the context of a bid; however, this trend and market practice is mainly used in the context of European-led bidding processes and is hardly implemented in Mexico. When using a vendor due diligence report, it is likely that sellers will have to provide reliance and even representations as to the accuracy, completeness and correctness of the vendor due diligence, opening the door to additional indemnification risk for the sellers/target.

In Mexico, advisers are required to put together a vendor due diligence report mainly in the context of cross-border due diligence processes where a local subsidiary is being sold as part of a global transaction, for which the sell-side has implemented a vendor due diligence.

However, it is not uncommon for legal advisers to take a leading role in advising in the context of an auction sale. In such cases, they typically conduct a focused and limited review of the most relevant aspects of the target's business, without performing full vendor due diligence reports. The aim of this is to assist the target's management and/or officers in navigating the legal due diligence process effectively, including tasks such as the proper and organised preparation of the virtual data site, responding to Q&A mechanics, participating in expert sessions, and addressing various other legal due diligence enquiries.

5. Structure of Transactions

5.1 Structure of the Acquisition

In Mexico, private equity transactions are generally private and are implemented through either:

- a purchase agreement, structured as a secondary transaction (ie, the fund acquires shares from existing shareholders), which approach is mainly used when the private equity fund is acquiring 100% of the target; or
- subscription or investment agreements, structured as a primary transaction (ie, the fund subscribes and pays for a capital increase of newly issued shares by the target, thus diluting the existing shareholders).

In conducting a privately negotiated transaction (as opposed to a bidding process), private equity funds have more leverage and are more aggressive in their positions, from a valuation standpoint through the definitive agreements. Another relevant feature when conducting private negotiations is the increased flexibility for parties to be creative in structuring and searching for alternative accommodation of the parties' needs.

From time to time, private equity funds also participate in bidding processes. Such a process generally aims to sell 100% of the equity of the target and is a seller-controlled process in respect of timing and economic and legal terms. In this process, multiple bidders compete and submit confidential bids for a target, including a position in respect of a draft purchase agreement that the seller makes available. This limits the ability to be aggressive in negotiating transaction documents and related negotiations, as the sell-side will consider – in addition to the economic offer – the ability to close expeditiously and the availability of a cash payment (ie, no acquisition financing). There are other disadvantages for private equity funds in bidding processes, including the need to be aggressive in the economic offer considering the competitive nature of the bid, offering a higher amount than may possibly have been agreed privately, and the expenses incurred in the process with the uncertain component of being able to successfully close a transaction.

5.2 Structure of the Buyer

The private equity fund does not invest directly, but uses a special purpose vehicle (SPV) for the particular transaction. The SPV used for the acquisition is led directly by the fund's internal team. The selection of the type of SPV and the jurisdiction of its incorporation is generally tax driven. Sometimes, the fund signs the initial agreement and then assigns its rights to the SPV ahead of closing the transaction.

5.3 Funding Structure of Private Equity Transactions

Private equity investments are conducted with a mix of equity and financing. For the purposes of the equity, private equity funds do provide an equity commitment letter, subject to general caveats such as due diligence.

In relation to financing, sellers generally ask that a commitment letter from a financial institution be delivered at signing. This provides sellers with the certainty that sufficient funds will be in place for closing and comes at a cost to the fund because a commitment fees is payable at signing. Financing could be in the form of a bridge loan to be refinanced following the acquisition, which is the more expensive option as the interest rates are higher, or a term loan, which is the more suitable option but also the one that takes longer. This has not changed over the last 12 months.

5.4 Multiple Investors

Consortiums

Consortiums are a standard structure conducting private equity transactions, specifically in instances where certain assets are limited for acquisition purposes or where the ticket is too high. Consortiums entail entering into agreements as to how the consortium will vote and/or conduct investments.

Co-investors

Co-investment is also a standard practice, particularly in respect of international private equity funds. In this case, the private equity fund negotiates the deal and incorporates another entity at the end. The sellers do not interact with the co-investor which, in many cases, is an institution such as a multilateral bank. These co-investors are passive and all the business and negotiation is fronted and carried by the fund.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Initial Cash Payment

In Mexico, the main form of consideration is an initial cash payment at closing based on a multiple of the enterprise value which is then subject to a closing or post-closing adjustment, mainly based on working capital, debt and cash. In some instances, such as a deal with a simultaneous sign and close, the price may be fixed and not subject to adjustment, as all pricing components are known at the time of closing.

Earn-out payments for existing shareholders

As mentioned before, the Mexican market has adopted as common practice the structuring consideration for private equity transactions of granting the existing shareholders earn-out payments based on a set of performance metrics that take into account the financial information for the ongoing year, future performance or a mix of both.

Rollovers for existing shareholders

Another form of consideration that comes in the context of private equity transactions is rollover for existing shareholders, whereby the existing shareholders receive equity in the acquiring entity and share limited corporate rights and full economic rights in addition to exit rights (and obligations) together with the private equity fund. This feature works well in the context of acquisitions where the private equity fund acquires 100% of the target and generally intends to conduct the target's operations. This consideration mechanism has its challenges, the main one being that it limits the amount of the cash-out consideration for the existing shareholders and could dissuade them from closing the transaction.

Deferred Consideration

Deferred consideration is a must in any mid-size or bigger transaction. Deferred consideration is the most efficient form of securing indemnification for potential known (assuming this is negotiated) or unknown contingencies that materialise within a period of time following closing. The main structures for negotiating a deferred payment are either (i) a holdback, whereby the buyer retains a portion of the purchase price and releases periodic payments (assuming no indemnification payments are required to be made), which is a pro-buyer/investor mechanism and is considered an aggressive provision; or (ii) an escrow, whereby the buyer deposits a portion of the purchase price with an independent third party (eg, a Mexican trust executed by a Mexican financial institution) which, in turn, releases funds pursuant to the trust agreement and upon instructions from the applicable parties. This is

the more moderate approach and the market standard for deferred payment.

Another way to structure deferred consideration is through an agreement between the parties to release payments as certain conditions are met, which is a pro-deal provision. These conditions may be based on the mere lapse of time or the achievement of specific milestones. This mechanism can be implemented in transactions involving deferred signing and closing, and it contributes to providing greater closing certainty. As the seller works towards fulfilling the agreed conditions, which, once met, justify the release of the agreed-upon payments, the buyer also receives the target under the expressly agreed-upon circumstances deemed necessary for its operation. This mechanism can be structured as a sellers' financing, including relevant debt features or simply a schedule of payments.

Leverage

Private equity buyers are generally more aggressive and have leverage. When structuring transactions, they aim to keep the existing shareholders on the hook for indemnification payments through holdback or escrows (which are often used to secure any potential price adjustment payments). Rather than having long discussions as to the security mechanism, private equity funds try to get the highest potential amount within the deferred payment structure. Holdbacks and escrows range from 5% of the purchase price (being a very low threshold and very aggressively pro-seller) to 25% or even 30% of the purchase price (being the highest threshold and very pro-buyer). To keep sellers on the hook, private equity funds try to pay a lesser amount of cash while retaining the sellers with skin in the game and motivating them to maximise their exit value with an earn-out and, potentially, through a rollover mechanism.

Private equity sellers try to sell and exit in an "as is, where is" structure, pursuant to which they get paid and no deferred consideration or other post-closing price adjustment remains. This is in part because at the time of exit, many funds are dissolved and all amounts have to be distributed, and private equity sellers strive to avoid having surviving liability. In this sense, when the fund is a selling shareholder, it pushes to avoid making representations in respect of the business, as the existing shareholders are those involved in the day-to-day operations. This is an instance where sellers push for R&W insurance to be included as part of the transaction so that there is no need to negotiate security mechanisms for indemnification payment.

A key concept in all these negotiation strategies is leverage, as leverage will determine how far an off-market position can go in the negotiation.

6.2 Locked-Box Consideration Structures

It is not typical in Mexico to have a locked-box consideration. Parties agree on an initial value, but that changes as the negotiation process moves along. Although upon signing binding agreements the agreed consideration remains, it is subject to the agreed-upon price adjustments (such adjustments can be made either at closing, or post-closing). In any event, when agreeing on a locked-box consideration, the seller is liable for leakages.

6.3 Dispute Resolution for Consideration Structures

When parties agree on a price adjustment mechanism, such mechanism includes a standard dispute resolution process. At or before closing, the sellers provide a closing statement identifying in good faith the amounts corresponding to each item of the adjustment and what they believe

the final price to be. Following closing, buyers have a period of 30–60 days to audit the target and get back to the sellers either accepting or refusing the amounts allocated to the items in the statement. There is then a period for the principals to negotiate in good faith and, where they fail to agree on one or more item, such items are submitted to a pre-agreed independent expert who will determine the amounts in respect of the disputed items. Such resolutions will be final and cannot be appealed.

6.4 Conditionality in Acquisition Documentation

In Mexico, the conditionality of private equity deals mirrors that of an M&A transaction. In addition to regulatory consents (ie, antitrust – COFECE, foreign investments – the CNIE), the second main type of conditions are those that require third-party approvals in respect of the business. These conditions include waivers or consents from financial institutions, as well as potential consent requirements from suppliers, landlords and so on.

Whether shareholder approval is required is based on the by-laws of each target, but in Mexico, to conduct a primary issuance of shares, a waiver from the existing shareholders is required in respect of their statutory right to subscribe and pay any capital increase proportionally. This is generally addressed at closing, within the corporate resolutions (which is a standard closing deliverable).

Additionally, given that Mexico is a highly regimented country, conditions may sometimes involve actions directly related to the proper functioning of the target, such as registering its intellectual property rights with the relevant authorities or ensuring that agreements with employees retained by the target comply with applicable Mexican labour law.

The following are conditions to any M&A or private equity transaction in Mexico – material adverse effect, the absence of judgments and orders, as well as true and correct R&W insurance. However, the importance and scope of these concepts varies from deal to deal, based on the parties, the industry and the current market conditions.

6.5 "Hell or High Water" Undertakings

"Hell or high water" provisions in Mexico are related to antitrust approval and, in respect of other regulatory approvals, they are negotiated on a case-by-case basis but are rarely seen, as antitrust agencies may impose conditions while other regulatory agencies may only approve or not approve the transaction.

"Hell or high water" provisions are considered aggressive and are not really customary in Mexico but they can be a starting point in seller-driven negotiations or in sellers' initial drafts.

Ultimately, parties should agree to share the risk of the authority approving the transaction with conditions, except for in very specific circumstances. It has become increasingly common to find "burdensome conditions" providing that if the conditions imposed by COFECE materially affect the buyer, then the buyer has the right not to close the transaction. This applies both for M&A and private equity deals.

6.6 Break Fees

Break fees in Mexico are more common in competitive processes than in private deals. The reason for this is that when a seller decides to close a transaction with a specific buyer to the detriment of others, the expectation is that a suc-

cessful closing will occur and the break fee will cover the trade-off of closing with another buyer.

Break fees range from 1% to 3% of the purchase price and the main triggers are – to the extent the buyer has an obligation – failure by the buyer to obtain regulatory approvals, failure by the buyer to secure financing, and breach by the buyer of the underlying purchase agreement.

6.7 Termination Rights in Acquisition Documentation

Termination provisions are fairly standard in Mexico. Agreements may be terminated by:

- mutual agreement of the parties;
- the buyer or seller if any of the conditions precedent to their respective benefit are not satisfied or become impossible to satisfy (provided that the other party is not in breach at such time);
- either party if the other party breaches the agreement; or
- either party not in breach if any of the conditions have not been met at the longstop date.

The longstop date varies depending on the type of transaction and the conditions applicable to it, but six months is the usual timeframe when antitrust approval is required.

6.8 Allocation of Risk

Allocation of risk for private equity buyers is the same or more aggressive than it is for corporate buyers (as private equity buyers strive to protect a fiduciary duty and justify investments before investment committees).

With regard to private equity sellers, they tend to be very risk averse and try to limit or, where possible, avoid, any surviving liability following closing, as previously discussed (see **6.1 Types of Consideration Mechanisms**).

6.9 Warranty and Indemnity Protection

As discussed before, private equity sellers try to avoid any business-related representations. If it comes to making representations, then a full package is expected from the private equity sellers (irrespective of management, as the fund will ultimately be liable for any indemnification payment).

When selling, private equity funds will try to negotiate a materiality threshold for a claim to be indemnifiable, a basket with a true deductible, and limit the liability to 5% or 10% of the purchase price at the most. In addition, they will push for a liability survival of maximum 12 months (except for fundamental representations and extended representations). The limitations discussed in this paragraph are those that are sell-side friendly. In respect of known contingencies, parties either adjust the price or agree on a specific indemnity that is not generally tied to the limitations negotiated. Parties also negotiate rights to defend any such known contingency.

6.10 Other Protections in Acquisition Documentation

All of these have already been addressed.

6.11 Commonly Litigated Provisions

The most-litigated provisions in the context of private equity negotiations are the scope of the representations and indemnification security, both as buyers and sellers. Metrics for earn-outs are also heavily discussed among principals. Finally, in respect of partial investments, corporate governance, exit rights and mechanisms for solving controversies are also heavily negotiated.

Furthermore, depending on the nationality of the sellers and buyers (ie, for tax purposes), provisions related to tax obligations and responsibilities become highly significant, such as filing of tax returns, straddle periods, refunds and post-closing actions.

7. Takeovers

7.1 Public-to-Private

The Mexican securities market is quite inactive and highly illiquid, thus the volume of M&A transactions taking a public company private is limited. Moreover, most public companies are controlled by private families, thus acquiring and delisting them is difficult. Assuming there is no tender offer, the board of directors of any such targets would generally request a fairness opinion prior to bringing the transaction to the shareholders for approval. Upon agreement, the parties would execute a transaction agreement setting forth the necessary steps for the transaction and very limited representations and warranties.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Any shareholder that reaches an ownership percentage of 5% or more in a public company must disclose their shareholding to the Mexican Stock Exchange, while a shareholder who reaches 10% ownership must file a notice with the Mexican Stock Exchange setting forth their ownership structure and any agreements related to the shares they own (ie, voting or otherwise).

The foregoing are the most relevant notices a private equity buyer must deliver. In addition to these, there are tender offer notices and filings which are dependent on the type of tender offer (ie, voluntary or mandatory).

7.3 Mandatory Offer Thresholds

The Securities Market Law sets forth that upon reaching a shareholding of 30% or more of the outstanding shares of a public company, the holder thereof (directly or through related parties) must conduct a tender offer for 100% of the outstanding shares. Such mandatory tender must be priced at least at the highest value paid by the acquiring shareholder over the last 12 months.

7.4 Consideration

As stated above in **7.3 Mandatory Offer Thresholds**, mandatory tenders must be priced at least at the highest value paid by the acquiring shareholder over the last 12 months. The market in Mexico is split in respect of consideration. While in some instances, mainly in respect of family-run businesses, consideration is paid in cash, there are more strategic tenders where payment is made with an exchange of shares.

7.5 Conditions in Takeovers

Tender offers in Mexico may be conditional. Such conditions may include a minimum percentage of acceptance of the offer, material adverse effect, regulatory approvals and obtaining financing. In addition to these conditions, there are instances where bidders may try to protect their tender offer by adding break fees, matching rights and exclusivity provisions.

7.6 Acquiring Less Than 100%

Bidders not seeking 100% ownership can strive to obtain other corporate governance rights such as seats on the board, certain veto rights or super-majority matters, as well as protections granting the bidder a right to consent in instances where their investment or shareholding could be affected. Information rights in addition to statutory disclosure obligations are also available.

Squeeze-outs in Mexico can be conducted through a tender offer; however, if unsuccessful or a minority interest remains within the ownership structure, majority shareholders may vote to buy out the minority shareholder or approve a share redemption, thus redeeming such minority's shares or, alternatively, to squeeze a party out through a long legal proceeding.

7.7 Irrevocable Commitments

In advance of the launch of a tender offer, bidders often obtain significant assurances from the controlling group as to the acceptance and main terms of the tender offer. Bidders aim for these commitments to be irrevocable, but a premium needs to be paid as the principal shareholders relinquish their right to seek other options by shopping the deal. Negotiations for irrevocable commitments generally occur within the weeks or months leading up to the launch of the tender offer.

Among the features included in these negotiations are the irrevocable nature of the acceptance, the right to accept another offer (if a new, higher and unsolicited offer is received), additional consideration and the duration of the offer.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

In an effort to achieve alignment between the investors and the management team, the private equity fund will generally grant stock options (or, sometimes, phantom stock) as equity incentive plans. The percentage ownership allotted to these plans is somewhere between 5% and 10% of the total common (or non-voting) stock.

8.2 Management Participation

Sweet equity is generally the type of stock covered by an incentive plan. The plan allows for management to receive part of the shares allotted to each member with the passing of time and to the extent the member remains working for the company. Shares vest over time as well. Additional shares may be granted if performance metrics are achieved.

In Mexico, management do not often obtain preferred shares. Such shares would be part of preferred distributions in the event of liquidity and payment of dividends.

8.3 Vesting/Leaver Provisions

Vesting of stock is standard in Mexican stock option plans. Vesting allows the company some certainty as it relates to the employee staying and their corresponding commitment to the company. Shares typically vest some time between three to four years.

Additionally, Mexico has adopted a "good leaver" and "bad leaver" concept. A good leaver is an employee who leaves for the right reasons and on good terms (including termination without cause) with the company and is generally entitled to keep their vested shares, and sometimes even negotiate payment for unvested shares, with the company. On the other hand, a bad leaver is an employee that is terminated for cause or otherwise leaves the company for the wrong reasons, in which case, the employee forfeits their unvested shares and the company buys back the vested shares at a penalty (ie, nominal valuation, at cost).

8.4 Restrictions on Manager Shareholders

The main restrictive covenants in Mexico are non-compete, non-solicitation, non-disparage-

ment and confidentiality obligations for members of management or key employees. These remain enforceable for the duration of the employment and for a year or two following termination (in some cases, this could go up to three years).

Whether these are part of the equity package, employment arrangement or standalone documents depends on the specific circumstances of the hiring.

8.5 Minority Protection for Manager Shareholders

The stock option shares generally enjoy minimal rights aimed to protect the grant and the percentage represented, but avoiding granting rights that are related to the business operation. These shares are granted vetoes regarding critical matters of governance and potential changes (ie, amending the rules of the plan, changing the rights of the shares subject to the plan) and also anti-dilution provisions. Standard information rights are granted as well.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

The level of control a private equity fund has in its portfolio companies varies based on the size of the investment and the percentage owned. Private equity has seats on the board of directors and veto rights over both the board of directors and shareholders' meeting (the main governing body in Mexico) regarding super-majority matters. Some of the matters for which vetoes are granted, include:

- amending the by-laws;
- conducting strategic transactions;
- approving the business plan;
- approving annual budgets;
- approving capital expenses and financing beyond certain thresholds;
- disposing of material assets; and
- hiring or removing of high-level executives (ie, the CEO and CFO).

Private equity investors have standard information rights.

9.2 Shareholder Liability

Generally, the private equity fund would have no liability; however, there are instances under the applicable law where the private equity fund may be deemed liable for the actions of the portfolio companies. Such circumstances include:

- piercing the corporate veil if the shareholders are deemed an extension of the fund;
- fraud; and
- when management of the private equity fund participates in management of the portfolio company.

10. Exits

10.1 Types of Exit

Unfortunately, in Mexico exiting through an IPO is an option that is difficult to explore as the market for IPOs has been dry. Private equity funds are exiting through either a sale of 100% of the shares of their private equity-backed company or by conducting secondary sales to other private equity funds. These are the typical ways in which private equity investors exit their investments. It is not standard to see rollovers or reinvestments from private equity in Mexico.

10.2 Drag and Tag Rights

Drag and tag rights are fairly standard in Mexico; however, these are rarely used, as informal

negotiations take place ahead of initiating the drag or tag processes. For drag-along provisions to be triggered, generally offers must be for 100% of the company. In some instances, for the drag-along to be triggered, a minimum consideration threshold must be obtained. Regarding tag-along rights, minimum thresholds generally start at 10%.

10.3 IPO

In light that there is no market for IPOs in Mexico, it is difficult to discuss recent trends. However, back in the day, standard lock-up periods ranged from six months to one year.

Trends and Developments

Contributed by:
Gabriel Robles, Héctor Cárdenas and Eric Silberstein
Ritch Mueller

Ritch Mueller is a top-tier multidisciplinary transactional firm committed to offering high value-added legal advice to national and international clients in the structuring, development and financing of their private businesses and public sector projects in Mexico. The firm works on transactions across various sectors including financial, industrial, infrastructure, energy, retail and services. With over 100 professionals, Ritch Mueller strives to deliver value to clients through an efficient and in-depth service, backed by extensive expertise and experience.

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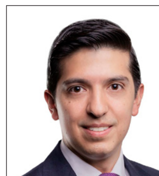

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Introduction

The Mexican private equity market is constantly evolving, and has seen significant progress since it first started. Over the past 20 years, the aggregate committed capital reached over USD71 billion, which represents a compounded annual growth rate equal to 10%, according to the Mexican Private Equity Association or "AMEXCAP".

A variety of players are active in the Mexican private equity space, including pension funds, sovereign funds, development banks and private investors.

Mexican institutional investors, primarily driven by pension funds (*admistradores de fondos para el retiro* – "AFOREs"), are the most relevant investors in terms of committed capital, and continue to invest in funds raised by local and international managers in a variety of sectors, including venture capital, growth capital, private credit, transportation, technology, real estate, energy and infrastructure.

AFOREs started investing in private equity around 2009, with new legislation passed allowing them to invest in public structures, subject to market regulations, issuing capital development trust certificates (*certificados bursátiles de capital de desarrollo* – "CKDs"), and subsequently in project investment trust certificates (*certificados bursátiles fiduciarios de proyectos de inversión* – "CERPIs"). The main difference between CKDs and CERPIs is that CERPIs may invest up to 90% of their capital contributions abroad (to the extent they invest 10% of such capital contributions in Mexico), while CKDs may only conduct investments in Mexico.

Nowadays, private equity funds can be raised as "public" structures, subject to securities market regulations, as well as "private" structures (ie, outside the scope of securities market regulations), or as a combination thereof.

In recent years, however, raising private equity funds through CKDs and CERPIs has proved more challenging. Even though AFOREs are only allowed to invest in publicly listed securities (such as CKDs and CERPIs), in the past, AFOREs have raised their own investment vehicles (in most cases, in the form of a CERPI, colloquially known as "auto-CERPIs"), which allow them to invest in private equity funds which issue securities that are not registered with the Mexican National Securities Registry, maintained by the Mexican National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores* – CNBV), and are not listed on a stock exchange. Such private funds have a structure very similar to CKDs and CERPIs, both in terms of corporate governance and management by a vehicle owned by the respective fund manager, and are in most cases the preferred structure as compared to CKDs and CERPIs, mainly because they allow private funds to be structured faster and more cheaply.

The largest AFOREs have prepared a list of non-negotiable terms and conditions applicable to private equity funds in which they participate, known as "deal breakers", which every fund manager is required to comply with and contemplate in the corresponding fund documents. These terms and conditions vary a lot from what are considered standard market conditions in other jurisdictions, and require consent from investors in decisions that are typically left to the fund manager.

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Challenges to Traditional Private Equity; the Surge of Private Credit Funds

On an ongoing basis, an increasing number of fund managers are transitioning from traditional growth equity funds to private credit funds.

What are the reasons for this surge in private credit funds? Traditional private equity faces significant challenges to successful exit strategies in Mexico, due to a relatively illiquid securities market. The lack of penetration of financial services in the general population, coupled with a limited number of institutional and qualified investors, low valuations and significant delays in the review process by Mexican regulators, has relegated the Mexican securities market as a viable exit strategy or even an attractive alternative for private equity funds. No primary IPOs from Mexican issuers have taken place since 2020, and the most recent IPO by a Mexican company was registered exclusively in the US, not in Mexico.

Thus, private equity funds are forced to explore other avenues to divest, as the funds' maturity dates come closer, including by conducting a traditional mergers and acquisition process, in order to sell to another fund or to a strategic or institutional buyer. Mexico's traditional M&A market is still underdeveloped as compared to those of other similar countries, which poses another challenge in successfully selling a company. For instance, the selection of private equity funds operating in Mexico, as well as institutional and strategic players, is relatively limited, and most Mexican private equity funds have focused their investment strategy on mid-market (or smaller) companies, with the hope of exiting through the public markets, which does not help increase the demand for private equity-backed assets. Having said that, a traditional M&A process is still, in practice, the most common exit strategy for private equity funds.

In this context, for private equity funds acquiring less than 100% of a company, negotiating shareholder exit rights, such as drag-along provisions, is instrumental to achieving a successful divestment. Considering that Mexico is a very regimented jurisdiction, negotiating not only exit rights, but structures that allow investors to effectively enforce such exit rights, has become increasingly critical for private equity funds in Mexico. Currently, the method typically used to allow enforcement of drag-along rights consists of incorporating a selling trust, into which all shares that may potentially be subject to a drag-along are contributed, which can be controlled by the private equity fund when exercising its drag-along rights.

In light of the lack of abundant exit strategies, Mexican private equity fund managers are now exploring exiting through continuation funds, with managers hoping that some, or the majority of, their investors will use these to roll over their interests in the existing fund. Closing a continuation fund with the existing investors of a private equity fund is still a challenge for the Mexican market, particularly considering that (i) AFOREs (which are the main investor in Mexican private equity funds) are typically not authorised to roll over their interests without a cash consideration; and (ii) rollovers in Mexico typically have adverse tax consequences for Mexican investors.

However, certain changes to the Mexican Securities Law were recently enacted (December 2023) to, among other things:

- amend the corporate regime applicable to publicly listed corporations (*sociedades anónimas bursátiles*), evidenced by –

(a) the elimination of a 25% ceiling to issue limited voting stock, which allows existing equity holders to maintain control of the issuer, while selling a significant stake in the company as part of the IPO; and
(b) the possibility to delegate the approval of capital increases and the terms applicable to the corresponding share subscription, from the shareholders' meeting to the board of directors of the publicly listed company; and

- regulate an expedited and simplified process to enable companies to conduct a public offer, known as a simplified registration process, in which case the CNBV's review and approval will not be required.

However, only institutional and qualified investors are entitled to purchase stock issued pursuant to a simplified registration process, which may limit the liquidity. Both traditional and simplified registration processes require the preparation of a prospectus or supplement and filing for registration with the CNBV or the corresponding Mexican stock exchange, respectively, which could attract new issuers and offer attractive exit strategies to private equity funds.

These recently enacted changes could help revive the Mexican securities market, and offer attractive exit strategies to private equity funds. Since the beginning of 2024, companies operating in sectors benefiting from nearshoring, such as logistics and transportation companies, have conducted follow-ons, which could be followed by first-time issues in the following months. Traxion's recent follow-on allowed local private equity funds, such as Discovery and Nexxus Capital, to sell a part of their percentage interest in such company.

Furthermore, limited access to credit for small and medium companies by the traditional banking system, even with the entry of new players, such as Nubank or Revolut, offers fund managers the opportunity to lend at high interest rates and avoid dealing with the complexities of instrumenting exit strategies applicable to traditional private equity. This, in part, has driven a surge in funds dedicated to private credit managed by local fund managers, as well as international funds lending in US dollars to Mexican companies, such as Victory Park Capital and Alloy Capital, to name a couple. It is probable that this trend is only just getting started and that a lot of fund managers will soon be raising new funds dedicated to private credit.

Nearshoring and New Opportunities

Real estate funds, especially those dedicated to industrial real estate, have continued to thrive with the opportunities offered by nearshoring and the need to have supply chains between Mexico and the rest of North America. International fund managers, such as Blackstone, are even exploring alternatives to acquiring industrial real estate portfolios, as evidenced by the recent bid for Terrafina, a Mexican REIT, which was ultimately acquired by another Mexican REIT, Prologis.

Other real estate sectors have also seen a surge, including hospitality in tourist areas, as well as commercial and residential opportunities in Mexico's largest cities.

One thing for international fund managers interested in investment opportunities in real estate assets in Mexicoto take into consideration when structuring such investments, is to necessarily contemplate a Mexican blocker vehicle to channel their investment, unless the fund is structured as a public REIT (*fideicomiso de infrae-*

structura en bienes raíces – "FIBRA"). This will allow the relevant fund to benefit from net taxation on rental income; otherwise, international investors of the fund will be subject to a very high 25% withholding tax on gross rentals.

During the past administration, investment in key sectors – such as energy, transportation and telecommunications – was halted and participation by the private sector largely decreased. Claudia Sheinbaum's new administration offers hope for new investment opportunities, as Mexico's president elect has promised to work closely with the private sector to invest in key sectors, such as renewable energies (mainly wind and solar), passenger trains and highways, among other things. This could translate into significant opportunities both for Mexican and international fund managers, such as Mexico Infrastructure Partners or Riverstone.

A number of initiatives are also being conducted by the public sector and supported by Mexican business organisations, such as the *Consejo Coordinador Empresarial* (CCE), to attract investments from sovereign wealth funds from the Middle East, as evidenced by the joint business council recently formed between the CCE and the Federation of Saudi Chambers of Commerce. Middle Eastern sovereign funds are poised to represent strategic private equity opportunities for Mexico and for local and international fund managers present in Mexico.

NETHERLANDS

Law and Practice

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Greenberg Traurig, LLP is an international law firm with over 2,750 attorneys serving clients from 47 offices in Europe, the USA, Asia, Latin America, and the Middle East. The firm's dedicated global private equity practice comprises more than 150 attorneys who regularly work with regional, national and global private equity firms advising them in connection with acquisitions, dispositions, financing transactions and fund formation. The practice also assists and advises portfolio companies, management teams, co-investors and other participants in all aspects of private equity transactions. The Amsterdam office of Greenberg Traurig has a full-service offering and is home to more than 100 professionals, including approximately 70 lawyers, tax advisers and civil-law notaries. The Amsterdam private equity practice handles straightforward and simple deals for those with novel and unique structures. It also handles multiple high-growth deals, control acquisitions, growth equity minority investments, and stressed and distressed transactions, for which it draws upon the vast resources of the firm's restructuring and bankruptcy practice.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

The indicators suggest that the private equity (PE) market will keep its momentum during the remainder of 2024. With inflation appearing to slow down in the eurozone (although still problematic in the US), the European Central Bank started cutting interest rates in the course of 2024. This has had a positive effect on the lending capacity and investment case of, in particular, private equity funds. In addition to the dry powder still available in the market, it is expected that this will drive the willingness of private equity funds to go after targets in a way that will gain traction on the sell-side.

This development is combined with a relatively full heritage sell-side pipeline (both for private equity as well as strategic parties), as the relatively long slowdown of the M&A markets in 2022/2023 delayed the start of many sales processes. For private equity, this has increased pressure on returning capital to investors. Assets relating to energy transition and the artificial intelligence solutions space have become particularly highly sought after, and valuations in these spaces have been on the rise.

Although the market is certainly improving, it is expected that deal-making will remain more challenging than in the peak year 2021 for a while. Private equity funds require more thorough due diligence and relationship building, which has made sell-side timelines stretch out. This is also caused by the more challenging financing environment and (looming) geopolitical tensions.

1.2 Market Activity and Impact of Macro-Economic Factors

While the Dutch and international M&A landscape in 2024 presents promising opportunities, there are obvious challenges that the market will face. Geopolitical factors, such as ongoing conflicts and tensions, related restrictive measures and sanctions, supply chain disruptions and export controls, will impact businesses and their valuation, and thereby M&A strategy. This impact will be felt in – among other sectors – advanced semiconductor manufacturing and, more generally, in the (deep) tech sector.

On the other hand, the drive to secure supply chains is expected to act as a catalyst for M&A activity across various industries in 2024, from automotive to healthcare to electronic components and chemicals. Bolt-on vertical acquisitions, strategic alliances and joint ventures are expected to ensure access to scarce resources and stability in supply chains for portfolio companies.

It is noteworthy that 2024 saw increased interest on the part of PE funds in medium-size accounting firms. On the other hand, PE's involvement in the Dutch healthcare sector has become the subject of public scrutiny and this has likely led to various exits in 2024.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Changes in the regulatory landscape have impacted PE funds the most during the last few years and transactions have been more heavily scrutinised by competition regulators. In addition, the new foreign direct investment (FDI) legislation that has come into force (see **3. Regula-**

tory Framework for more details) is impacting the structuring of deals, and the Corporate Sustainability Reporting Directive could soon have an impact on PE-held large portfolio companies as from reporting for FY 2024 onwards.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

In the Netherlands, the Authority for Financial Markets (*Autoriteit Financiële Markten* or AFM) is the primary supervisor for investment fund managers that are licensed or registered under the Alternative Investment Fund Managers Directive (AIFMD). The AIFMD captures private equity managers. The AFM is responsible for the initial licensing process and ongoing supervision in respect of conduct and compliance. The Dutch Central Bank (*De Nederlandsche Bank* or DNB) is involved in prudential supervision on ensuring the soundness of financial enterprises and the stability of the financial system. Private equity transactions may be subject to merger clearance, foreign direct investment review, EU foreign subsidies review and, possibly, sector-specific regulatory approvals (eg, for financial institutions, healthcare or utilities targets). The most notable and relevant authorities for PE funds are outlined below.

Merger Control

The Netherlands Authority for Consumers and Markets (ACM) is the Dutch competition authority responsible for merger control. A mandatory pre-merger filing in the Netherlands is required for a transaction – whereby a direct or indirect change of control is contemplated – if, in the last calendar year:

- the combined worldwide turnover of the companies concerned was EUR150 million or more; and
- the turnover in the Netherlands of each of at least two of the companies concerned was EUR30 million or more.

In case of a notification, a so-called standstill obligation applies, whereby a proposed transaction may not be effected until clearance has been obtained (effecting a transaction prematurely is called "gun-jumping").

In addition, the ACM monitors compliance with Dutch competition law. In M&A transactions, parties need to be aware when negotiating certain clauses, such as protective covenants, which may exceed the limits of what is necessary for (the implementation of) the transaction. Furthermore, in the period up to completion of the transaction, the parties should ensure that the transaction is not effectuated, for example, by the purchaser exercising decisive influence over the target, and that the parties do not share commercially sensitive information, in both cases, to protect against the risk of gun-jumping.

Foreign Direct Investment

On 1 June 2023, the broad Dutch National Security Investment Act (*Wet veiligheidstoets investeringen, fusies en overnames)* or NSI Act entered into force, introducing a new screening procedure/foreign investment review framework under Dutch law, in addition to those set out in sector-specific legislation. The notification requirement resulting from the NSI Act applies irrespective of the nationality of the acquirer. The NSI Act applies to certain acquisition activities in relation to a target company established in the Netherlands that is one of the following: (i) a vital provider; (ii) a provider or managers of a corporate campus; or (c) an undertaking active in the field

of sensitive technology. A corporate campus is defined as an enterprise that manages terrain on which a combination of businesses is active and where, with co-operation between the public and private sector, innovative technologies are developed. When in scope, the transaction needs to be notified to the Ministry of Economic Affairs, which will, in consultation with the Investment Screening Bureau (*Bureau Toetsing Investeringen* or BTI), assess the transaction. A standstill obligation applies until clearance has been obtained.

EU Foreign Subsidies

In 2023, the EU Foreign Subsidies Regulation (FSR) entered into force, thereby creating a screening regime aimed at combating distortions of competition on the EU internal market caused by foreign subsidies. The FSR imposes a mandatory pre-notification to the European Commission for transactions involving: (i) a target generating turnover in the EU of at least EUR500 million; and (ii) an acquirer and a target that have, together, received more than EUR50 million in foreign financial contributions in the previous three years in aggregate. Notifiable transactions must obtain clearance from the European Commission before they can close, creating a standstill obligation.

Sector-Specific Approvals

In addition to the above, transactions may be subject to a sector-specific approval. For example, approval may be required from the Dutch Central Bank or the AFM for transactions in the financial services sector. Certain transactions in the healthcare sector may be subject to the approval of the Dutch Healthcare Authority (*Nederlandse Zorgautoriteit* or NZa). Sector-specific approval or specific notifications may also be required in the utilities and telecommunication sectors.

4. Due Diligence

4.1 General Information

Potential purchasers typically conduct thorough legal due diligence. This is particularly the case for private equity transactions, which often involve debt financing and more complex deal structures compared to corporate investments. Legal due diligence is aimed at identifying potential legal risks and liabilities that could have an impact on the envisioned transaction, any historic risks and liabilities, as well as any issues that could undermine the value drivers underlying the growth projections of the target business. Typically, buy-side advisers will prepare an issue-based legal due diligence report that outlines material findings and includes recommendations on how to address the identified risks. Sometimes, more descriptive reports are required by PE funds, especially if third parties such as banks, insurers or co-investors are involved.

Legal due diligence is typically conducted by reviewing all the relevant documentation that has been made available through a virtual data room (VDR). The VDR usually provides a Q&A tool which allows the advisers of the potential purchaser to raise questions with the sell-side. Typically, legal expert sessions with key management personnel are conducted to clarify issues and gather insights into the business of the target company. Depending on the nature of the target business, common key areas of the legal due diligence are corporate, finance, commercial contracts, employment and pensions, real estate (title and/or lease), environment, litigation, intellectual property, information technology and data protection.

4.2 Vendor Due Diligence

It is common, although not strictly necessary, to prepare vendor due diligence (VDD) reports or a legal fact book in transactions that are structured as an auction sale and geared towards the successful bidder taking out warranty and indemnity (W&I) insurance coverage. Such VDD reports are typically divided into legal, financial, tax, commercial and sometimes insurance and environmental aspects of the target business, and would be prepared by the advisers retained by the seller. The primary reasons for preparing a VDD report include an increase in transaction speed, as a VDD report can expedite the transaction process by pre-emptively addressing potential issues and providing a potential purchaser with a comprehensive overview of the target company, and improving transaction certainty, by identifying and mitigating risks early. It also helps the selling PE fund to better compare bids. Typically, no reliance would be provided by sell-side legal advisers to W&I insurers, although reliance is sometimes provided by legal advisers on the VDD reports to the lenders providing acquisition financing.

5. Structure of Transactions

5.1 Structure of the Acquisition

Private equity transactions are typically structured as the sale and purchase of all shares in the target company from the legacy shareholders to a business and industrial development corporation (BidCo) vehicle which is incorporated by the PE fund (as part of a string of acquisition vehicles, depending on structuring). Compared to an asset deal, a share deal may be considered relatively straightforward as all assets (and liabilities) of the target company change ownership through the transfer of the shares in the target company. Sellers of the target and management often (re-)invest part of their proceeds in the BidCo vehicle (or one of its newly incorporated holding companies). This creates an alignment of interests, since the management board is incentivised (through an envy) to achieve future value creation.

Auction sale processes continue to be prevalent in the Dutch market to facilitate an exit for PE funds. These are almost always structured as a clean exit for the seller by aiming for a soft- or hard-stapled W&I insurance policy that is to be taken out by the buyer. W&I is also sometimes used to facilitate one-on-one transactions (typically when these are negotiated on a non-exclusive basis).

Although not as common in the Netherlands compared to the standard private acquisition structure described above in terms of transaction volume, PE sponsors also engage in public-to-private (P2P) transactions which have a vastly different structure and process. For more information on P2P transactions, see **7. Takeovers**.

5.2 Structure of the Buyer

In the Dutch market, several Dutch or non-Dutch private limited companies – for example, a BidCo, holding company (HoldCo) and top company (TopCo) – are typically set up as special purpose vehicles (SPVs) by the PE sponsor. A structure such as this is prevalent for a variety of reasons, among others, for ring-fencing liability, facilitating (re-)investment by the target's management and the sellers, and for financing purposes. The PE fund itself typically does not become a party to the transaction documents other than the (already existing) shareholders' agreement at the TopCo level.

5.3 Funding Structure of Private Equity Transactions

A PE acquisition is usually financed with both equity and debt to create the leverage a PE fund requires as part of its business model. In auction processes, the seller will typically require a combination of debt and equity commitment letters to be provided that guarantee payment of the purchase price at closing. A seller would prefer the debt commitment letters to be provided on a fully committed financing basis, implying that any conditionality included therein is under the control of the buyer, which is contractually bound to proceed with the transaction in any event. However, sellers have been forced to appreciate that fully committed financing debt commitment letters have become more challenging for bidders to obtain in the last 12 months due to the macro-economic environment.

5.4 Multiple Investors

Co-investment deals are not uncommon in the Dutch market, and their popularity has increased somewhat over the last few years. Typically, these are limited partners taking passive stakes alongside the general partner of the PE fund, granting these limited partners additional upside on specific investment opportunities selected by the general partner. Sellers also sometimes reinvest in the target company through a combination of investing in the acquiring PE fund as a limited partner and alongside the PE fund as a co-investor. Consortium deals are not uncommon, and are sometimes also carried out for sector knowledge purposes – a certain corporate or PE sponsor may be more familiar with an industry or market compared to its co-investor. In other words, not only capital but also knowledge is pooled.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

The predominant form of consideration structure used for PE entries and exits in the Netherlands remains the locked box mechanism (LBM), especially as foreign investors have become more familiar with this concept. A strong PE sponsor may negotiate use of a completion accounts mechanism (CAM) for certain entries, especially if there are serious doubts regarding the (unaudited) financial accounts or if these pertain to (complex) carve-out sales. There may also be valid reasons why a seller would press for a CAM. In a standard LBM a buyer assumes the benefits and risks of the target company as per an “effective date”, typically the date of the last audited financial statements, and the enterprise-to-equity-value bridge is determined as per the selected effective date. In a CAM, the enterprise-to-equity-value bridge is determined as per the closing date (or a date close to the closing date). An LBM fosters greater price certainty and is therefore the preferred mechanism for sellers, especially PE sellers who need certainty on providing returns to their investors, and the timing thereof. A CAM may give a buyer (a sense of) more comfort that the business was conducted in a profitable manner in the period prior to the closing date. Earn-outs, vendor loans, deferred considerations and reinvestment structures are a common feature of PE transactions, and are typically sought after by investing PE funds.

6.2 Locked-Box Consideration Structures

There are roughly two starting points for equity ticker negotiations in the Netherlands: (i) the equity ticker should be a proxy for the cash-generating capacity of the target for the economic interim period; and/or (ii) the equity ticker

should reflect the risk-free rate (whether or not with a mark-up) to compensate the seller for the fact that it will receive the sale proceeds after transferring the target's economic benefits. Sometimes, this is expressed as an interest rate on the equity value for the duration of the period between the effective date and closing. Charging interest on leakage that occurs during the period between the effective date and closing is not typical, but is also not unheard of.

6.3 Dispute Resolution for Consideration Structures

It is common to include an independent expert procedure in the transaction documentation for both leakage disputes arising under LBM deals and for purchase-price adjustment disputes arising under CAM deals. The scope of work for such an independent expert varies accordingly. Typically, an independent firm of chartered accountants is appointed by the parties as the independent expert and the share purchase documentation lays down the mechanics on how such independent expert will be appointed if the parties cannot mutually agree on one specific firm. If part of the consideration is in the form of an earn-out, an independent expert procedure will typically also apply to any disputes in this respect (eg, if there is a discussion on the achievement of certain EBITDA targets).

6.4 Conditionality in Acquisition Documentation

It is not common to have any conditions to closing other than those conditions which are legally required to consummate the transaction, such as regulatory clearances: merger clearance, sector-specific clearance or foreign direct investment approvals. Financing conditions are not typical, although these have become more sought after by buyers during the recent period of market uncertainty with high interest rates and geopolitical tensions. In certain instances where there is a significant interim period between signing and closing (resulting from regulatory approvals), material adverse change (MAC)/material adverse effect (MAE)-like conditions may be required by PE buyers. Third-party consents are usually not accepted as conditions to closing, although the termination by third parties of (material) supplier or customer agreements sometimes results in a discount of the purchase price or a breach of covenants. These mechanisms are bespoke and tailored on a case-by-case basis.

6.5 "Hell or High Water" Undertakings

"Hell or high water" provisions are not uncommon in the Dutch market, albeit these are rarely accepted if the regulatory analysis shows that obtaining approvals may prove difficult. Typically, PE buyers would refrain from accepting these obligations, although competitive processes may force their hands. On occasion, hell- or-high-water provisions are introduced by sellers in respect of obtaining FDI approvals. It will be interesting to see how the market develops in this respect.

6.6 Break Fees

A break fee payable by the buyer to the seller (or vice versa) if the transaction does not close is not typical in the Netherlands for private deals, although sometimes break fees are linked to the buyer not obtaining regulatory approvals. In public deals, a break fee of around 1% of the equity value is common, but this can be higher in specific circumstances.

6.7 Termination Rights in Acquisition Documentation

Deal certainty is crucial for all the parties involved in the transaction. To foster deal certainty, parties typically try to contractually limit the termination possibilities as much as permitted under

Dutch law (eg, by having a claim for damages be the sole remedy in case of a breach, thereby excluding the right to rescind the transaction documentation) other than for non-satisfaction of closing conditions or failure to meet specific obligations at closing. The sale and purchase agreement (SPA) contains tailored termination mechanics in this respect. The long-stop date is typically linked to the estimated timeframe to obtain regulatory approvals, plus a buffer to cater for eventualities.

6.8 Allocation of Risk

PE-backed sellers are typically more determined to achieve a clean exit than corporate sellers. This desire for a clean exit is mainly sought after by PE funds to facilitate the free distribution of the sale proceeds to limited partners without any contingent liabilities. To foster a clean exit, W&I policies are typically used more often in PE-initiated sales processes than those initiated by corporates, although W&I has become a common tool for corporates as well (especially in auctions).

6.9 Warranty and Indemnity Protection

Typically, PE sellers are willing to provide a customary set of warranties (categorised into business, fundamental and tax warranties) and a tax indemnity, provided that these are insured via a W&I insurance policy with no residual liability for the respective seller (sole and exclusive recourse), although PE sellers are sometimes willing to accept an exception for fundamental warranties for which the PE sellers remain (partially) liable.

Depending on the deal size and type of business conducted by the target, the following monetary limitations in respect of business warranties and tax warranties are typically seen: a de minimis threshold of approximately 0.1% of the enterprise value (EV), a tipping basket of approximately 1% of the EV and a liability cap ranging anywhere between 10% and 25% of the EV in respect of the business warranties, and between 10% and 25% of the EV in respect of the tax warranties. Fundamental warranties are typically excluded from any limitation-of-liability provisions, other than a general cap of 100% of the purchase price. Business warranties are typically limited in duration to anywhere between 12 and 24 months after closing, with parties often ending up agreeing on a period of 18 months. Fundamental warranties are provided from anywhere between three to ten years after closing, while tax warranties have a duration of seven years after closing or such later date, being six months after the statutory limitation period for such claims – including the term during which additional assessments can be imposed – has lapsed in respect of a breach of the tax warranties.

It is customary practice in the Dutch M&A market to make the business warranties and tax warranties subject to a general data room disclosure. Although disclosure letters are used in the Dutch M&A context, such letters usually serve a different purpose compared to those, for example, of the US market. In the US, disclosure letters are often used as the sole means of disclosure while in the Dutch market, they typically serve as a means to ensure proper and undeniable disclosure is made (or in the W&I context, to reduce the warranties and tax indemnity at closing).

It is fairly uncommon in the Dutch market today for the management team to provide warranties separately, whether or not via a separate management warranty deed that is covered by a W&I policy.

6.10 Other Protections in Acquisition Documentation

W&I insurance policies have become increasingly popular, as these provide flexibility to the PE funds to distribute the transaction proceeds to their limited partners, thereby bringing forward the moment of return on the limited partners' investment. The liability of the PE seller for a breach of the warranties and the tax indemnity is thereby typically limited to one euro (except sometimes for a breach of fundamental warranties). PE sellers are very reluctant to accept any specific indemnities for known risks (which specific indemnities are by nature uninsurable in principle) that circumvent the W&I policy but, depending on the circumstances, may well prefer a specific indemnity over a debt item in the EV bridge. W&I insurance almost always comes in the form of a buyer policy, and as such has the characteristics of a general insurance contract as opposed to a liability insurance contract. W&I insurance is subject to a certain liability cap typically ranging from between 10% and 30% of the EV (depending on the offer in the non-binding indication report and the risk appetite of the insurers). There have been comebacks of escrow/retention arrangements in PE entries in respect of uninsurable claims such as specific indemnities, any leakage claims (if a locked box is used) or any true-up claims, when determining the equity value post-closing (if completion accounts are used).

6.11 Commonly Litigated Provisions

Litigation is not a typical aspect of PE deals but of course, disputes occur and these may be litigated. There has recently been an increase in disputes relating to intra-group relationships between the target on the one hand and management-related companies on the other hand. Furthermore, earn-outs are historically considered to be prone to disputes due to the many intricacies involved in such mechanisms. Careful negotiation of any earn-out (including clear key performance indicators and anti-abuse provisions) is very important to mitigate any post-closing dispute in this respect.

7. Takeovers

7.1 Public-to-Private

Although there is generally a larger volume of private M&A transactions than public M&A transactions, public-to-private deals by PE-backed bidders are quite common in the Netherlands. Given the overall challenging market dynamics for private equity in recent years, there have recently been more strategic take-privates. However, as in the private M&A market, PE does typically have a large share of the market in terms of takeovers of listed targets.

PE is generally dependent on target management and will therefore not normally entertain a hostile offer. Normally, a PE bidder would enter into a merger protocol with the target before announcing its intention to launch a public offer. The merger protocol will include arrangements on the offer process and terms and conditions for the bidder to launch its offer. In addition, a practice has developed in the Netherlands whereby, if the bidder does not achieve an acceptance rate of at least 95% of the target shares at the end of the acceptance period, the target company will co-operate with a squeeze-out of the remaining shareholders. This is a so-called "pre-wired" back-end structure. The common threshold on which the boards feel they have sufficient mandate to co-operate with the squeeze-out is 80%, although thresholds may vary depending on the circumstances.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

The AFM must be notified without delay by anyone who acquires or disposes of shares or voting rights that cause the percentage of capital or votes to reach, exceed or fall below certain thresholds of listed companies. Such notification obligation also applies for the acquisition or disposal of financial instruments that represent a short position with respect to shares of a listed company. The relevant thresholds that trigger an obligation to notify are the following: 3%, 5%, 10%, 15%, 20%, 25%, 30%, 40%, 50%, 60%, 75% and 95%.

The 30% threshold is particularly relevant for private equity-backed bidders contemplating a tender offer, as this threshold also triggers a mandatory offer on all outstanding shares of the listed companies (see **7.3 Mandatory Offer Thresholds**).

7.3 Mandatory Offer Thresholds

A takeover bid is legally required in the Netherlands once a person or entity – alone or in concert with others – acquires control over a listed company, which is defined as being able to exercise at least 30% of the voting rights in the general meeting of a Dutch company on a regulated market. A mandatory offer must be made at a fair price. This means that the minimum price of a mandatory offer must be the highest price paid by the bidder in the year preceding the announcement of the mandatory offer. Any non-compliance with the mandatory offer rules can be sanctioned by the Dutch Enterprise Chamber which may, at the request of the company and others, impose a mandatory offer.

7.4 Consideration

Bidders can offer cash or shares, or a combination of both in a public offer. Pursuant to the best-price rule, the bidder must pay the higher of (i) the offer price and (ii) the highest price paid by the bidder to acquire shares on the market, unless the transaction was a regular trade on a regulated market.

7.5 Conditions in Takeovers

A public offer is usually subject to “commencement conditions”, being the conditions that must be satisfied (or waived) for the bidder to launch the offer, and “offer conditions”, being the conditions that must be satisfied (or waived) in order to declare the offer unconditional.

Common commencement conditions include:

- no breach of the (material provisions of the) merger protocol;
- absence of a material adverse change;
- no change in the board’s recommendation;
- compliance with employee consultation procedures;
- no legal prohibition of the public offer; and/or
- no suspension of trading of the target company’s shares.

Similar conditions typically apply as offer conditions. In addition, the following conditions generally apply:

- a condition that all regulatory approvals have been obtained; and
- a condition that a certain minimum acceptance threshold has been met.

Finally, the adoption of certain general meeting resolutions (eg, dismissal or appointment of directors) that will become effective upon settlement of the offer is generally included as an offer condition.

A public offer cannot be conditional on the bidder obtaining financing. The bidder must announce that it has ultimate certainty of funds when filing the draft offer memorandum for approval with the AFM. Additionally, a bidder cannot include conditions which are under the control of the bidder.

In contrast to a voluntary public offer, the completion of a mandatory offer may not be made subject to any conditions.

7.6 Acquiring Less Than 100%

If a private equity-backed bidder does not obtain 100% ownership of a target but does acquire at least 95% of the shares, it can make use of a squeeze-out mechanism under Dutch law. A shareholder that has at least 95% of the shares may request the Enterprise Chamber, within three months after the acceptance period of the offer has lapsed, to force the minority shareholders to sell their shares. The bidder and target may agree that if the bidder's shareholding exceeds a lower threshold, in practice often around 80%, the target will co-operate with alternative squeeze-out mechanisms such as an asset sale or a (triangular) legal merger.

If a bidder does not acquire 100% ownership of a target, it may strengthen its governance rights by, for example, entering into a shareholders' or voting agreement with another major shareholder or concluding a relationship agreement with the target company. Such agreements typically include provisions regarding governance rights, and may include a nomination right for one or more members of the supervisory board. They may also include share transfer restrictions or orderly market arrangements.

The implementation of a debt push-down is not prohibited by Dutch law. However, in order to be able to achieve a debt push-down into the target following a successful offer, the private equity-backed bidder must ensure that it can realise the incurring of debt in the target company. This is often a management board decision which requires the approval of the supervisory board and the general meeting.

7.7 Irrevocable Commitments

Shareholders of the target company may give irrevocable commitments to accept a public offer if and when launched. Shareholders that hold a substantial interest are often approached before an intention to make a bid is made public and therefore inside information is often shared. This is permitted in the Netherlands if the will of such shareholder to tender the shares is reasonably required for the decision to make an offer. The commitments given by shareholders are often conditional ("soft") commitments, since unconditional ("hard") commitments do not allow the shareholder to terminate the agreement once a better offer is made.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentivisation of the management team is a common feature of private equity transactions in the Netherlands. Typically, management may be entitled to a non-voting minority of the share capital. Ownership is typically steered towards only economic upside. Governance rights are typically limited to fundamental minority protection rights.

8.2 Management Participation

A broad range of management equity incentive arrangements is available in the Netherlands, including (combinations of) "sweet" equity plans, ratchet/performance shares, long-term incen-

tive plans, exit bonuses, and stock appreciation rights schemes. "Sweet" equity plans typically entitle management to invest in ordinary shares, potentially granting substantially higher exit proceeds as compared to the PE fund's holding of ordinary shares, after repayment of debt, shareholder loans and preference shares. By contrast, the PE fund will invest in a combination of preference shares and ordinary shares, with the preference shares delivering a compound fixed return making up the largest part of the capital at entry, resulting in an "envy" for management. Certain key managers may also be invited to invest on equal economic terms alongside the sponsor. This institutional strip is generally subject to a lighter regime in terms of leaver provisions.

8.3 Vesting/Leaver Provisions

Leaver provisions typically oblige each manager to offer their management incentive stake to the PE sponsor (or a person designated by the PE sponsor) upon the occurrence of a leaver event. The manager will be categorised as:

- a "bad leaver" – typically a leaver who is dismissed for urgent cause, certain reasonable termination grounds as defined under Dutch employment law, voluntary resignation other than for good cause (death, serious illness, etc), material breaches of transaction or employment documentation, commission of crimes of personal bankruptcy, etc; or
- a "good leaver" – generally a leaver for any reason other than a bad leaver; or
- an "early leaver".

The relevant consideration for the leaver shares will typically depend on the leaver classification (good, bad or early) and the timing of the departure (typically linked to the moment on which the leaver event occurred). Good leavers will typically receive fair market value, subject to a customary vesting scheme. Bad leavers will typically receive the lower of fair market value and acquisition costs. Early leavers will receive a tailored discount.

8.4 Restrictions on Manager Shareholders

In the Netherlands, restrictive covenants such as non-compete and non-solicitation restrictions, are typically imposed as part of both the equity package and the employment/management contract. The enforceability of non-compete restrictions is limited by antitrust laws and the Dutch law principle of reasonableness and fairness (*redelijkheid en billijkheid*). A Dutch court can modify or nullify any overly restrictive term.

8.5 Minority Protection for Manager Shareholders

Governance rights for management are typically limited to fundamental minority protection rights, including in relation to the exclusion of pre-emptive rights other than for rescue financing or add-on acquisitions (at the discretion of the PE fund). Typically, a PE fund will not permit management to have any elaborate operational veto rights, and also not regarding the suspension, appointment or dismissal of directors. A PE fund will, in principle, not accept/steer away as much as possible from any hampering of its discretionary exit rights.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

A private equity shareholder will negotiate key rights to maintain (substantial) influence over its portfolio companies to protect its investments and minimise associated risks. Typical provisions relating to control include hire-or-

fire mechanics, wherein the private equity fund shareholder has the right to appoint, suspend or dismiss members of the management board. Private equity funds will negotiate an elaborate list of reserved matters which, for example, either require the approval of the private equity fund in the general meeting of shareholders of the company or of a delegated member of the supervisory board of the company. Private equity shareholders require elaborate information rights which include monthly financial reporting and the immediate reporting of key events. Typically, private equity shareholders will negotiate the discretionary right to initiate an exit process, including by means of a drag-along right.

9.2 Shareholder Liability

In the Netherlands, a shareholder's liability is, in principle, limited to its investment and its obligation to pay the nominal value on its shares. Case law shows that there are certain instances where a shareholder can be held liable in respect of the liabilities of its portfolio companies, for instance, where such shareholder has accepted distributions from its portfolio company, which subsequent deficit results in the portfolio company's bankruptcy. Furthermore, the corporate veil can be pierced in instances where a portfolio company breaches European or domestic competition laws. As part of the intensive monitoring of their portfolio companies, the PE sponsor should be wary if and when the portfolio company enters into financial difficulties.

10. Exits

10.1 Types of Exit

There are multiple exit strategies for PE funds, including private sales to other private equity-backed investors or corporates, IPOs, management buy-outs and recapitalisations. The most common exit strategy for private equity is a private sale. Dual-track processes happen, but over the last few years have not been common. Triple-track exits – whereby the possibility of a recap is prepared in parallel – are fairly rare. Roll-over situations where a private equity seller reinvests (through a different fund under management) have become increasingly popular.

10.2 Drag and Tag Rights

Private equity investors will negotiate drag-along rights in order to gain a high degree of control over a future sale of the portfolio company. Typically, this drag-along right is matched by a tag-along right negotiated by co-investors and management. Drag-along rights enable selling majority shareholders to force minority shareholders to participate in a sale and offer their shares, whereas tag-along rights offer the minority shareholders the right to participate in a sale and sell their shares at the same price and terms as the selling shareholder(s). In practice, private equity investors are reluctant to accept any hampering of their drag-along rights, including by means of agreeing to a minimum return threshold.

10.3 IPO

An IPO can be a viable exit strategy for private equity and can provide high returns. An IPO can offer a full or partial exit, but on most occasions a significant minority stake is sold while a majority is retained by the PE sponsor to demonstrate trust and confidence to the market. Private equity sellers conducting an IPO often agree to be bound by a lock-up arrangement that lasts around six months after the IPO, during which they may not sell their shares. In specific instances, the lock-up period can be up to 12 months. If the private equity seller retains a substantial stake in the IPO company, the issuer and seller may enter into a relationship agreement that will govern the private equity investor's role as shareholder.

Trends and Developments

Contributed by:
Maarten de Boorder, Rutger Sterk, Bas Vletter and Samuel Garcia Nelen
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Greenberg Traurig, LLP is an international law firm with over 2,750 attorneys serving clients from 47 offices in Europe, the USA, Asia, Latin America, and the Middle East. The firm's dedicated global private equity practice comprises more than 150 attorneys who regularly work with regional, national and global private equity firms advising them in connection with acquisitions, dispositions, financing transactions and fund formation. The practice also assists and advises portfolio companies, management teams, co-investors and other participants in all aspects of private equity transactions. The Amsterdam office of Greenberg Traurig has a full-service offering and is home to more than 100 professionals, including approximately 70 lawyers, tax advisers and civil-law notaries. The Amsterdam private equity practice handles straightforward and simple deals for those with novel and unique structures. It also handles multiple high-growth deals, control acquisitions, growth equity minority investments, and stressed and distressed transactions, for which it draws upon the vast resources of the firm's restructuring and bankruptcy practice.

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Introduction

Riding out the wave of M&A transactions from 2021, both 2022 and 2023 proved challenging years for M&A and private equity (PE). Although deal activity did not come to a complete halt, the market had a particularly slow start in 2023. Transactions started picking up in the second half of the year, but most activity was concentrated in the mid-market, with the large cap deal market being down. Later in the year, PE activity in the Netherlands demonstrated a strong recovery, particularly in the fourth quarter. In fact, while strategic deals decreased slightly, the fourth quarter of 2023 saw the highest quarterly private equity-involved deal count over the past two years.

The outlook for 2024 is now confidently more positive. Despite ongoing geopolitical uncertainties and persistent macroeconomic challenges, there are signs of economic recovery. The continuing decline in inflation, expected to fall from 4.1% in 2023 to 2.9% in 2024, and stabilising interest rates, along with considerable dry powder at private equity firms, are contributing to a more favourable M&A landscape for PE sponsors. However, the future of the M&A recovery remains unpredictable due to lingering macroeconomic and geopolitical challenges, and sticky inflation in the United States.

Expectations for 2024

The outlook is optimistic that the M&A markets will continue to gain momentum during the rest of 2024. With inflation slowing down in the eurozone, the European Central Bank (ECB) started cutting interest rates in the course of 2024, which had a positive effect on the lending capacity and investment case of, in particular, private equity, and which raised valuations. Consequently, this will drive the willingness of private equity bidders to go after targets and make offers at levels that will gain traction at the sell-side.

This development is combined with a relatively full heritage sell-side pipeline (both for private equity as well as strategic parties), as the relatively long slowdown of the M&A markets in 2022/2023 delayed the start of many sales processes. For private equity, this will increase pressure to consider returning capital to investors.

Particularly assets that relate to the energy transition space and artificial intelligence-based solutions space have become highly sought after, and valuations are rising rapidly. Specifically, the year 2024 saw an increase in interest on the part of PE in medium-size accounting firms. PE's involvement in the healthcare sector has become the subject of public scrutiny and this has led to various exits in the year 2024.

Although the market is improving, deal-making will remain more challenging than in 2021 for a while. Also due to the still more challenging financing environment, buyers require more thorough due diligence and relationship building, which has made auction sale timelines stretch out.

Further challenges can arise from macroeconomic and geopolitical factors, including in particular the (aftermath of) elections in multiple countries and regions (such as the US and the EU), and regulatory scrutiny, all of which may impact foreign investment.

Current Trends and Developments

Geopolitical challenges and the drive to secure supply chains

While the Dutch and international M&A landscape in 2024 presents promising opportunities, there are obvious challenges. Geopolitical

factors, such as ongoing conflicts and tensions, related restrictive measures and sanctions, supply chain disruptions and export controls, will impact PE's M&A strategy. This impact will be felt in – among others – advanced semiconductor manufacturing and, more generally, in the (deep) tech sector.

On the other hand, the drive to secure supply chains is expected to act as a catalyst for M&A activity across various industries in 2024, from automotive and healthcare to electronic components and chemicals. It is expected that vertical bolt-on acquisitions, strategic alliances and joint ventures will ensure access to scarce resources and stability in supply chains for portfolio companies.

Private capital – focus on stable returns

For years, there has been growth in investments by private equity players in certain asset classes like infrastructure. The common denominator of these classes is that they offer stable returns and have minimal exposure to economic downturns.

A strong sector focus and the ability to differentiate as niche investors will be key in 2024. The services and infrastructure sectors are particularly busy, while sectors such as healthcare and tech are less susceptible to volatility and are expected to continue to perform well, even though PE investments in the healthcare sector have become subject to public scrutiny.

Private equity – focus on equity underwriting and co-investments

Private equity firms are expected to place greater emphasis on their ability to equity underwrite deals due to increased costs for debt financing. The ability to execute co-investments might be especially relevant when pursuing larger deals.

Energy transition remains a strong M&A driver

Both private equity and strategic buyers, across all industries, are increasingly considering deals in the sustainability sphere as a way to achieve growth and improve their business operations, while also raising their ESG profile. These parties are pursuing deals pertaining to businesses and technology in the energy transition field, including new technologies for power and electricity generation, decarbonisation, energy storage and circular business models such as recycling. As such, this sector is poised to witness favourable trends in 2024, with anticipated growth in both deal value and volume.

Capital will continue to flow into this sector since investors expect the energy transition to become increasingly important in achieving net-zero goals. With capital expected to drift away from assets that are not compatible with the net-zero transition and toward opportunities that are, certain industries and sectors may inevitably struggle to secure the required funds. However, the opportunities and new technologies that are compatible with the net-zero transition are expected to increasingly benefit from government (equity) funding (fuelled by government regional investment funds, such as Invest NL, and government subsidies).

In this context, enterprises with a strong balance sheet will be best positioned to profit from potential deals and opportunities to create value. Enterprises that struggle may find themselves to be the object of consolidation, for example, in the oil and gas industry.

Tech investors are looking for value in AI

After a difficult period for tech, investments in this sector are increasing, although these investments are mostly limited to certain subsectors.

This is primarily driven by the demand for commercial maturity and broader application of AI-based solutions, and a halt in the increase of interest rates (especially relevant for valuations of long-term venture investments). Such demand has not only pushed innovation, but also fuelled M&A activity.

The more mature players are looking to acquire AI-related businesses to enhance their own businesses and stay ahead of the curve. Start-ups specialising in AI have attracted significant investment from major private capital investment firms and tech companies, paving the way for potential M&A deals during the coming years.

The focus on ESG has penetrated business society, with companies increasingly trying to adopt climate tech solutions to address ESG challenges. This focus shift creates opportunities for tech investors and their portfolio companies that provide solutions aligned with ESG principles, driving M&A activity in this space.

Life sciences assets are resilient to economic volatility and remain attractive to investors

There is an optimistic sentiment in the market in relation to an expected increase in activity in the life sciences field, as healthcare assets are resilient to economic volatility and remain attractive to investors. Obviously, navigating antitrust and foreign direct investment rules will remain important in any contemplated transaction in the life sciences sector.

Venture capital investments in the biotech sector were limited last year. This is partially attributable to valuation misalignment, which resulted in biotech companies falling back on insider rounds or convertible instruments, such as convertible loan notes. However, there is potential for a recovery in biotech funding through venture capital investments, especially once capital markets re-open as an exit route.

Financing trends – alternatives to bank financing are on the rise

The availability and cost of debt was a constant discussion during 2023. The higher interest rates resulted in lower valuations. In addition, since private equity portfolio companies are typically leveraged with variable interest rate debt, the financing cost of these companies unexpectedly increased, resulting in a substantial reduction of cash after debt service. These factors resulted in situations where private equity investors had to accept lower valuations when selling their portfolio companies, which required a shift in thinking. The gap between seller and buyer expectations on valuation often resulted in parties failing to reach an agreement and terminating negotiations. These negative developments were strengthened by the banks' decreased appetite to lend significant funds, especially in the large-cap segment, due to uncertainties in the economic climate.

The gap between seller and buyer expectations on valuation continues to be a prevalent theme, and will likely lead to the use of creative consideration mechanisms such as earn-outs or share considerations. With banks tightening their belts, direct lenders (such as credit funds, frequently managed by larger PE funds) have gained market share, particularly in acquisition financing. These direct lenders have a preference for buy-and-build initiatives, giving the lenders the opportunity to deploy more capital.

Increased scrutiny of foreign investment

Over the last few years, an increasing number of jurisdictions have subjected foreign and national investments to prior screening by means of a system known as "foreign direct investment

screening". On 1 June 2023, the Netherlands introduced its National Security Investment Act (*Wet veiligheidstoets investeringen, fusies en overnames*), known as the NSI Act. Based on this new legislation, investments that pose risks to Dutch national security can be blocked. The act is country-neutral and as such applies to Dutch, non-Dutch and non-EU investors. In essence, the NSI Act establishes a national security regime, rather than a foreign direct investment regime.

The NSI Act is based on national security considerations relevant to the maintenance of democratic order, state interests and social stability. More specifically, those considerations that relate to ensuring the uninterrupted functioning of vital processes, safeguarding the exclusivity of knowledge relating to sensitive technologies/vital processes and averting the creation of undesirable strategic dependencies.

Accordingly, the NSI Act establishes a screening procedure only for investments targeting vital providers, companies active in the area of sensitive technologies, and operators of business campuses. A company that operates, manages or makes available a service the continuity of which is vital to Dutch society is considered a vital provider. This includes key financial market infrastructure providers like significant banks, payment services providers and trading platforms; main transport hubs (Schiphol Airport and the Port of Rotterdam); heat network or gas storage operators; and extractable energy or nuclear power companies.

The NSI Act will have a substantial impact on acquisitions in the Netherlands. It will require careful assessment of whether a transaction falls within its scope. Parties should expect an additional administrative burden and an impact on their transaction timetables if their M&A activities fall within the scope of the NSI Act.

The introduction of the EU Foreign Subsidies Regulation

The EU Foreign Subsidies Regulation (FSR) entered into force on 12 January 2023 and created a regime aimed at combating distortions of competition on the EU internal market caused by foreign subsidies. It imposes mandatory notification and approval requirements on acquisitions of businesses with significant EU operations and large EU public tenders, and gives the EC the power to launch ex officio investigations. The notification obligations have been fully applicable since 12 October 2023.

Companies that are active in the EU (or plan to invest in the EU or participate in EU public tenders) and that have received "financial contributions" from non-EU countries, need to put in place systems for gathering the information required for FSR. To avoid delaying transactions, any company potentially active in larger M&A transactions having an effect within the EU should start preparations well in advance.

Notifiable transactions must be approved by the EC before they can close, creating a standstill obligation. Given the above, companies contemplating an M&A deal should consider FSR, in addition to foreign direct investments and other regulatory aspects. Besides the impact of FSR on the transaction itself, the FSR should also be taken into account in the context of the due diligence of the target.

Fund structure and compensation

After considering a listing for a while, CVC Capital completed its IPO and debuted on the Amsterdam stock exchange in 2024. This is in line with a longer trend of PE sponsors growing from

small private firms with a few partners to large, institutionalised asset managers that represent huge amounts of intrinsic value. The advantages of being listed for PE sponsors are numerous. Among other things, this can add flexibility to compensate and retain personnel. The share price of most listed private equity firms has risen in 2024, demonstrating the optimistic outlook of the private M&A market as well as the robustness of the PE earnings model. Compensation of PE sponsors remains a hot and political topic in the Netherlands. For example, the largest Dutch pension fund (which is one of the largest pension funds in the world) was vocal about its frustration with the amount of compensation paid to fund managers. Furthermore, there are ongoing discussions within PE sponsors themselves on how any earned carried interest should be distributed among partners.

NEW ZEALAND

Law and Practice

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Russell McVeagh employs approximately 350 staff and partners across its Auckland and Wellington offices. The firm's private equity team is a market leader in New Zealand and has represented some of the largest and most high-profile domestic and offshore private equity funds. The team has significant experience in advising on all aspects of private equity-led transactions, including acquisitions, divestments, bolt-ons, financing, and tax issues associated with structuring and fund formation. Russell McVeagh has a deep understanding of the key drivers and issues faced by private equity sponsors, and collaborates with experts across its full-service practice to manage any issues that arise from complex, high-value private-equity transactions. Russell McVeagh's private equity lawyers work across the specialities to deliver advice on a broad range of issues, to local and international clients ranging from NZX 50 corporates to private equity and fund managers.

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Russell McVeagh

1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

This chapter provides an overview of the key trends and features of a "private equity transaction" in New Zealand – that is, an acquisition (or disposal) of a target business where the buyer or the seller is a special-purpose vehicle that is ultimately owned by a fund or funds which are managed and/or advised by a private equity fund manager.

The New Zealand Private Capital Monitor 2024 reported that transaction activity in 2023 returned to pre-COVID-19 levels, with significantly more investments than divestments across private equity and venture capital funds.

Overall M&A activity reduced in 2023, with the number of premium private equity transactions significantly decreasing. However, there was a slight increase in the number of mid-market transactions.

Various economic conditions, including the recent (technical) economic recession in New Zealand, high interest rates and general election (further expanded on in **1.2 Market Activity and Impact of Macro-Economic Factors**) contributed to the decrease in pace of M&A activity in the second half of 2022 which continued into 2023 and early 2024. Bid-ask valuation gaps continue to impact transaction volumes with funds focusing on volume growth via operational improvement and funding investor returns through alternative strategies such as partial sales and sales to secondary funds. However, there are promising signs of M&A activity in New Zealand picking up in the latter half of 2024.

As previously noted, whilst 2021 and 2022 were "seller's markets" in New Zealand, with many formal sales processes taking place, this trend reversed in 2023, resulting in an increase in deals implemented by way of private treaty/bilateral process.

While slower than previous years, the current private equity market remains relatively strong, due to the following:

- the availability of quality domestic assets;
- a perception of New Zealand as a relatively safe and stable governmental/regulatory environment; and
- an abundance of "dry powder" (ie, available committed capital) on the part of domestic, regional and international private equity funds.

1.2 Market Activity and Impact of Macro-Economic Factors

In terms of types of transactions, as noted in **1.1 Private Equity Transactions and M&A Deals in General**, as noted above, there has been a reduction in formal sale processes.

From a sector perspective, in recent years there has been a particular increase in transactions in:

- infrastructure (core and core plus) – for example, the acquisitions of Vector Metering and intelliHUB, and the sale of Hiway Group by Riverside to local PE fund Direct Capital;
- healthcare – for example, Pacific Equity Partner's disposition of Evolution Healthcare, Permira-backed I-MED Radiology's acquisition of Hamilton Radiology and Midland MRI, and the acquisition of Habit Health by Five V Capital from Livingbridge; and
- take privates generally – for example, the (at the time of writing) proposed takeovers of The

Warehouse Group by Adamantam Capital and the proposed take private of Arvida Group by Stonepeak.

Notably, renewable energy and telecommunications, media and technology (particularly, artificial intelligence) are sectors that are gaining investor attention.

As mentioned in **1.1 Private Equity Transactions and M&A Deals in General**, transaction activity slowed down in the latter half of 2022 and this has continued into 2023 and early 2024. This is likely due to New Zealand's challenging economic conditions such as the recent technical recession and high interest rates. These challenges were exacerbated by general election uncertainty (New Zealand's election took place in mid-October 2023 and resulted in a change of government).

In particular, the high interest rates have tempered the relative ease of access to financing sources at reasonably favourable lending rates in New Zealand. With high interest rates, less debt is available, in turn impacting leveraged buyouts. However, given New Zealand private equity funds are not typically as highly leveraged as those in other jurisdictions, the decrease in availability of debt has had a lesser impact on M&A activity than has been observed in other jurisdictions.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

New Zealand's Overseas Investment Regime

New Zealand's overseas investment regime is relatively complex (though well-advised investors can expect to navigate it successfully in most cases). There has been a variety of changes to this legislation in recent times. A full summary of the regime is set out in **3.1 Primary Regulators and Regulatory Issues**.

Focus on ESG

An emphasis by private equity buyers on environmental, social and corporate governance (ESG) matters is currently being seen, prompted by an increased focus by institutional investors such as superannuation funds. This is, and will likely continue to be, a key focus in M&A decision-making, particularly in respect of due diligence going forward.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Primary New Zealand Regulators

Two key questions govern the regulation of share acquisitions in New Zealand.

- Does the acquisition constitute "takeover activity" regulated by the Takeovers Act 1993 and the Takeovers Code (the "Code")?
- Is the acquisition otherwise regulated in New Zealand?

These are summarised as follows.

Does the Acquisition Constitute "Takeover Activity" Regulated by the Code?

What is a Code Company?

The Code regulates the change in control of voting rights in companies ("Code Companies") that:

- are listed on a regulated market, including the New Zealand Stock Exchange (NZX);

- have been listed on a regulated market in the last 12 months; and/or
- have 50 or more shareholders and 50 or more share parcels and is at least medium-sized.

Accordingly, private companies (unless recently delisted or widely held) will generally not constitute Code Companies.

The "fundamental rule" under the Code

The fundamental rule under the Code prohibits any person (or persons acting jointly or in concert, or as associates) from acquiring an interest of 20% or more in a Code Company (a "Control Transaction" and "Control Interest").

Who are the relevant regulators from a Code perspective?

The New Zealand Takeovers Panel (the "Panel") regulates takeovers of Code Companies, the underlying principle of this regulation being that all shareholders (no matter their relative size or influence) have equal, informed opportunities to participate in major share transactions. The Panel has the power to exempt persons from a provision of the Code and/or modify the application of the Code in a particular case. If the target Code Company is listed on the NZX, the NZX also has powers of supervision over a takeover, under the NZX Listing Rules. The Panel and NZX work together collaboratively.

If the target company is dual-listed on the Australian Securities Exchange (ASX), as is reasonably common for NZX-listed companies, the ASX and, potentially, the Australian Securities and Investment Commission, will also have a regulatory role in the matter.

If the proposed Control Transaction is structured by way of a scheme of arrangement (see further in this section), the New Zealand High Court will be required to review and sanction that scheme.

Is the Acquisition Otherwise Regulated?

Commerce Commission

The Commerce Commission New Zealand (NZCC) is New Zealand's regulator of competition, fair trading and consumer-credit contracts. Its main role is to enforce the Commerce Act 1986, alongside a list of additional legislation.

The NZCC works under a voluntary notification regime, meaning that there is no legal requirement for a seller or buyer to notify the NZCC in respect of a potential acquisition. However, notification is encouraged, especially when the relevant transaction could substantially lessen competition in a market. A buyer can apply to the NZCC either for clearance (that is, the NZCC is satisfied the merger will not substantially lessen competition in the market) or for a formal authorisation (allowing an acquisition even if it does substantially lessen competition in a market).

In these circumstances, the sale and purchase agreement for the transaction (SPA) will normally include a condition stating that NZCC approval is required before the transaction can go ahead. Once notified, depending on the level of complexity of the clearance application, the NZCC will typically take between 40 and 130 days to make a decision and issue a statement. The NZCC seeks to be as transparent as possible, which means that its decision and any submissions made are published on its website. However, a party may request that certain information remain confidential.

Financial Markets Authority

The Financial Markets Authority (FMA) is New Zealand's regulator for securities law and finan-

cial reporting. Most of the FMA's work is carried out under the Financial Markets Conduct Act 2013 (FMCA). The FMA generally has a limited practical role in mergers and acquisitions, in that there is no requirement to consult with the FMA in relation to a proposed transaction or seek its consent. However, depending on the nature of the target business and the acquisition (by way of example, the form of consideration to be provided), the FMCA may be relevant.

Overseas Investment Office

Private equity buyers proposing to invest directly or indirectly in New Zealand will need to be aware of the country's inbound foreign direct investment regime contained in the Overseas Investment Act 2005 (OIA) and associated regulations, which is overseen by the Overseas Investment Office (OIO).

New Zealand's overseas investment regime is known as being one of the more complex on a global scale; however, in the vast majority of cases, well-advised buyers can generally expect to navigate it successfully. OIO consent is not always required, but when it is required, the application process is relatively intensive and the time required to obtain consent will need to be factored into the relevant transaction's overall timetable. Where it is determined that OIO consent is required, the SPA will need to be expressly conditional on the receipt of the relevant OIO consent. Current market practice is to file an OIO consent application shortly after signing the SPA. OIO consent can take around two-and-a-half months (or longer, in some cases) to obtain, depending on the nature of the target asset, the consent required and the buyer. The regime is structured to ensure that the OIO has the power to review a relatively large proportion of transactions for the purpose of ensuring New Zealand's interests are adequately protected, but at the same time to encourage beneficial overseas investment. In a very small proportion of cases, the OIO will decline consent if the factors for consent are not met.

Whether a transaction requires consent depends on one or a combination of the value and/or nature of the New Zealand assets that are affected by the transaction. A transaction that will directly or indirectly result in the acquisition of a more than 25% ownership or control interest in a New Zealand business or New Zealand assets will require OIO consent if the gross value of the New Zealand assets or the purchase price for (or which is attributable to) the New Zealand business or assets exceeds NZD100 million. Higher monetary thresholds apply for buyers from countries with trade agreements with New Zealand that meet certain requirements.

OIO consent will also be required if a buyer directly or indirectly acquires a more than 25% ownership or control interest in an entity that holds a qualifying interest in "sensitive land" (what constitutes "sensitive land" is relatively detailed, but broadly speaking, includes any residential land, land directly adjacent to the foreshore, any non-urban land over five hectares and certain forestry rights).

The consent requirement is triggered even if the acquisition occurs offshore, further up the corporate chain. In each case, consent is also required if a buyer proposes to increase an existing more than 25% direct or indirect ownership or control interest in "significant business assets" or "sensitive land" through the 50% and 75% control thresholds, or to 100%. This consent requirement for creep transactions can catch out upstream investors in global businesses that have significant downstream assets or land interests in New Zealand where the buyer

increases its proportionate interest by participating in a non-pro rata fundraising or buy-back transaction.

On average, significant business assets consent takes approximately two months to obtain, and a sensitive-land consent can take between four and five months from submission – since the recent election, the government has tasked the OIO with reducing consenting timeframes, and there are already OIO consents being issued significantly more quickly than in recent years. In the case of regulated offshore transactions and large multinational transactions where the New Zealand business is a small component, the OIO can be persuaded to prioritise the application and consent can often be obtained in six to eight weeks for significant business assets applications.

In addition to the significant business assets and sensitive-land consent pathways, there is a separate "national-interest" test, which grants the Minister of Finance a broad discretion to prohibit or impose conditions on transactions that otherwise require consent, and which are considered contrary to New Zealand's national interest. The national-interest test will mandatorily apply (in addition to the applicable significant business assets or sensitive-land consent requirement) where either the buyer is a "non-New Zealand government investor" or the transaction involves land or assets that are used in a "strategically important business". The definition of a "non-New Zealand government investor" is complex, but in broad terms the test will apply if the buyer is, or its upstream owners are, more than 25%-owned, directly or indirectly, by one or more government-related entities (such as sovereign wealth funds, state-owned enterprises (SOEs), public pension funds and their associated entities) from a single country. This will often apply to private equity funds, depending on the size and composition of their limited partners' base.

Even in cases where OIO consent is not required under the usual significant business assets or sensitive land pathways, buyers will still need to consider whether the transaction involves New Zealand land or assets that are used in a "strategically important business". If so, the transaction will be subject to the "national security and public order call-in power", which allows the Minister of Finance to call in the transaction for review and to block, impose conditions on or unwind the transaction if the Minister considers it poses a significant risk to New Zealand's national security or public order. This power is intended to be used very rarely. Notification is voluntary, except in certain specific cases.

Reserve Bank

The Reserve Bank of New Zealand (the "Reserve Bank") is New Zealand's regulator of banking, insurance and non-bank deposit-takers. Its main purpose is to promote the maintenance of a sound and efficient financial system. In instances where there is to be a significant acquisition by a New Zealand incorporated registered bank, Reserve Bank approval will be required. This approval can be incorporated into transaction documentation as a condition to the contract being completed.

NZX

On a transaction involving a sale or purchase by an NZX-listed entity, the NZX will have a role in monitoring compliance with the NZX Listing Rules (for example, rules relating to continuous disclosure and approval of material transactions).

Other sector-specific regulation
Depending on the nature of the target business, other New Zealand regulators may be relevant in the context of a transaction.

4. Due Diligence

4.1 General Information

Private equity buyers in New Zealand will typically carry out detailed due diligence investigations.

The extent of this review will vary, however, depending on the following factors:

- the nature of the target business;
- the buyer's existing sector expertise, and the extent to which it is already familiar with the business;
- the proposed level of shareholding to be acquired by the private equity buyer (ie, a minority or control stake);
- the buyer's overall risk appetite and its budget for advisory fees;
- the extent to which detailed seller due diligence has been undertaken and provided to the buyer; and
- whether the buyer is required to obtain warranty and indemnity (W&I) insurance and tax indemnity in the SPA.

Due diligence will typically be undertaken in respect of financial, tax and legal aspects. In some cases (depending on the factors previously outlined), private equity buyers will undertake diligence in respect of commercial, insurance, environmental, engineering (eg, where the target has specific critical tangible assets), ESG, anti-bribery and corruption/anti-money laundering and IT aspects.

A typical legal due diligence review for a private equity buyer will focus on the following areas:

- corporate structure;
- regulatory and compliance matters;
- material contractual obligations (focusing on terms underpinning key revenue streams and the identification of material provisions such as termination rights (including on change of control), exclusivity provisions/restraints of trade and liability under warranties and indemnities);
- finance arrangements (noting that this will probably be a limited review, given existing external debt will be refinanced as part of the transaction);
- real estate;
- employment (focusing on accrued employee benefits, contractual terms for key executives and the involvement of any relevant unions);
- intellectual property;
- information technology; and
- privacy/data protection and litigation and investigations.

4.2 Vendor Due Diligence

As previously noted, with M&A activity declining from the second half of 2022, which has continued into 2023 and early 2024, there has been an increase in deals being implemented by way of private treaty/bilateral process, resulting in longer deal processes and heightened scrutiny by buyers when conducting due diligence.

Prior to this (ie, 2021 and 2022 when M&A activity was high), there were a large number of formal sale processes whereby it was common for a private equity seller to provide seller due diligence (VDD) reports to a shortlisted group of bidders (typically accounting, tax and legal, and often commercial and insurance reports as well).

The provision of a VDD report benefits the seller in that:

- it permits the due diligence process to be truncated (also, the process is more attractive to bidders as it reduces their transaction costs), and reduces workload on management of the business during the buyer due diligence phase;
- key issues that may impact transaction implementation, or the value of the target business, are identified up front and potential solutions can be investigated, or the issue can be explained away; and
- the existence of VDD reports generally assists in ensuring that any W&I underwriting process is straightforward.

The existence of VDD reports, however, does not replace the need for a buyer to conduct due diligence. External buyer advisers will customarily conduct a full review of the VDD, including verification of sample materials and a "gap analysis" (aside from being prudent, this will generally be required as a condition to any bank financing and as part of any W&I underwriting).

Reliance on VDD reports will customarily be given to the successful bidder, via reliance letters provided by the relevant VDD advisers.

5. Structure of Transactions

5.1 Structure of the Acquisition

The typical structure of a private equity acquisition depends on whether the target is public or private.

Non-code Companies

As previously noted in **3.1 Primary Regulators and Regulatory Issues**, a widely held or recently delisted private company may constitute a Code Company, in which case the acquisition structure will generally be the same as for a publicly listed target, as set out in this section (unless an exemption from the Code is granted by the Panel).

Otherwise, an acquisition of a non-Code Company will typically be effected through a negotiated SPA.

Business/asset purchases are fairly rare in this space, as the seller will inevitably wish to divest itself of target business liabilities via a share sale.

As previously noted, whilst during 2021 and 2022 it was a "seller's market" in New Zealand, with many formal sales processes taking place, this trend has reversed with the current economic downturn, meaning that there is an increase in deals implemented by way of private treaty/bilateral process.

In a formal process, competitive tension inevitably impacts on the form of the sale documentation – typically, the SPA will be more seller-friendly than that which might be negotiated in a private treaty sale (in particular, sellers will be very focused on certainty of closing, and will be averse to conditionality – see more in **6.4 Conditionality in Acquisition Documentation**).

Code Companies

A "Code Transaction" will be effected:

- as a takeover offer under the Code ("Takeover Offer") (which may be a full or partial offer);
- by an acquisition or allotment of voting securities above the control threshold which has been "white-washed" by an ordinary resolution of the target;

- pursuant to "creep" provisions for holders of more than 50% and less than 90% (less than an additional 5% in a 12-month period); or
- by a court-approved scheme of arrangement ("Scheme"), approved by 75% of the votes of the shareholders of the Code Company entitled to vote (and 75% approval by any separate interest group).

If a buyer acquires 90% or more of the voting securities of a target, it can rely on compulsory acquisition provisions to acquire the balance of the voting shares.

Increasingly, Schemes are becoming the preferred (though not exclusive) route for private equity public acquisitions, in view of the following factors:

- the lower shareholder-consent threshold to obtain 100% ownership of the target than a takeover (generally, 75% for a Scheme versus 90% for a takeover); and
- Schemes generally permit a longer time-period to obtain any requisite regulatory approvals (eg, OIO or NZCC), although regulators will generally try to adhere to timeframes prescribed by the Code (it is also possible to obtain a limited set of warranties, backed up by W&I, for a Scheme).

It is usual for Control Transactions in New Zealand to be conducted on a consensual, "friendly" basis, as opposed to hostile takeovers (which are very rare). In this context, the buyer and seller will often enter into an agreement, which contains deal protection mechanisms such as "no-talk" and "no-shop" provisions, the requirement for irrevocable undertakings, any break fee arrangements and the key terms of the offer to shareholders (see further **7.1 Public-to-Private**).

5.2 Structure of the Buyer

The buyer in a New Zealand private equity transaction is typically a New Zealand-incorporated special-purpose vehicle (Bidco) established by the private equity buyer specifically for the purpose of the acquisition. Bidco will normally have a holding company and an interposed entity for funding (Finco). Other intermediary special-purpose vehicles may be interposed if required (by way of example, there may be a secondary Finco if it is proposed that mezzanine debt is introduced into the structure). Typically, these companies will all be incorporated in New Zealand and are almost always incorporated as limited-liability companies.

The only capacity in which a private equity fund will enter into transaction documentation is as a party to an equity commitment letter (see further **5.3 Funding Structure of Private Equity Transactions**).

5.3 Funding Structure of Private Equity Transactions

In New Zealand, private equity transactions are generally financed by a mixture of equity funding and senior debt.

Certainty of equity funding is customarily evidenced by an equity commitment letter provided by the private equity fund, customarily enforceable by the seller. This provides comfort to the buyer that there will be committed funds available to Bidco at closing.

Where the private equity fund also intends to use debt, it will typically provide a debt-commitment letter at signing from the relevant lender(s), which will attach either a term sheet or a facility agreement. Despite the current market uncertainty (see further **1.2 Market Activity and Impact of Macro-Economic Factors**), there continues

to be strong lender appetite to participate in financing private equity deals which are backed by quality sponsors. Further, there is a growing number of international and (to a more limited extent) domestic private credit platforms that are providing debt finance to support private equity deals in New Zealand.

Private equity buyers customarily acquire some or all of the shares in a target entity, to ensure it has control of the target business post-completion.

Where a non-control stake of a target is being acquired, this would typically be funded via equity only (senior lenders will be reluctant to advance funding where there is not clear control on the part of the investor, unless it is funded directly into the target business).

5.4 Multiple Investors

Examples of domestic and offshore funds partnering together are becoming more common (by way of example, Pencarrow and Accel-KKR in relation to Seequent and Pioneer and SilverTree in relation to Agility CIS). Consortium bids on larger transactions such as take-privates and deals in the infrastructure space (for example, the recent consortium acquisition of Tilt Renewables via a scheme of arrangement) have also been seen.

Generally, however (given the relatively small size of the New Zealand market, and comparatively lower deal sizes), consortium bids are less common than in other jurisdictions and it is more typical for private equity sponsors to seek sole ownership of portfolio companies. That said, it is not unusual to have co-investment from other investors alongside the private equity fund (generally in the form of a passive stake as a limited partner).

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Overall, most transactions tend to be undertaken by way of a completion accounts mechanism. Prior to the COVID-19 pandemic and subsequent economic downturn, there was increasing use of locked-box structures in SPAs and, on balance, private equity sellers would have a slight preference for using locked-box arrangements. In the absence of compelling reasons otherwise (see further below) this is generally accepted by private equity buyers (particularly in a competitive bid scenario). Corporate buyers, however, have typically preferred to favour a completion accounts mechanism.

Two key factors are relevant to the consideration of appropriate consideration structures in the current climate:

- if OIO or other regulatory consents are required as a condition to completion of the acquisition, the time-periods required to fulfil that condition may mean that completion is set to occur a significant time after the latest audited accounts (noting that these will customarily be the basis of the locked-box balance sheet referenced in the SPA); and
- with the ongoing impact of COVID-19 and other macro-economic factors (such as inflation), buyers are either demonstrating an ongoing concern around the risk of business disruption between the locked-box date and completion or an unease to assume the economic risk over that period, which would make the position at the locked-box date less reliable.

Where a completion accounts mechanism is used, corporate sellers may be prepared to

accept that a portion of the purchase is placed into escrow (or retained) to cover relevant adjustments. Private equity sellers will resist this, though it may be a matter for negotiation (again, in a competitive bid situation, this would impact negatively on a bid).

In the current climate, where there is significant uncertainty due to potential business disruption (often resulting in significant gaps between a seller's perceived deal value and what a buyer is prepared to pay), increasingly, earn-outs and deferred consideration are being seen as a feature in SPAs. These are, by their nature, complicated arrangements, and care needs to be taken in terms of drafting to ensure any such provision properly protects the commercial position of both parties.

6.2 Locked-Box Consideration Structures

It is reasonably common for locked-box consideration structures to include a requirement for the buyer to pay to the seller an additional amount from the date of the locked box accounts until completion. This will typically be based on an interest rate on the enterprise value or equity value of the target business (to be negotiated) or at a rate reflecting the cost of capital for the target business.

In some circumstances (for example, where there is a long period between the locked-box date until completion due to OIO requirements), the parties may negotiate for the rate to ratchet upwards after a certain time-period.

It is not common to see interest charged on any leakage payment.

6.3 Dispute Resolution for Consideration Structures

It is uncommon to have a separate dispute-resolution regime for locked-box disputes. These are typically only subject to the dispute resolution provisions in the SPA (customarily New Zealand courts).

However, it is common for there to be a requirement that any dispute in relation to completion accounts should be referred to an independent expert for determination (which will be binding on the parties, except in the event of manifest error or omission).

6.4 Conditionality in Acquisition Documentation

This section covers non-Code transactions. For transactions involving Code Companies, see **7.5 Conditions in Takeovers**.

The objective of any seller in New Zealand, whether corporate or private equity will be to have as few conditions as possible.

There are two customary categories of conditions, as follows:

- any conditions required from a legal/regulatory basis – for example, OIO or NZCC consent, or shareholder approval for a listed entity in accordance with the NZX Listing Rules (a Regulatory Condition); and
- assuming a Regulatory Condition is required, the buyer will usually seek protection for the period between the signing and closing of the SPA in the form of a material adverse change (MAC) clause (although in a competitive bid situation, it may look to differentiate its bid by limiting or omitting this concept, depending on the nature of the target business and its appetite for any related risk).

If there is a Regulatory Condition, a seller will typically require that as much of the work (as is possible) required to satisfy that condition is done prior to the signing of the SPA, to minimise the conditional period. By way of example, in a competitive bid situation where the acquisition is subject to OIO approval, the seller will usually expect that the buyer has progressed its application in parallel to the SPA, in order that it can submit this as soon as possible following signing (or alternatively, in advance of signing).

MAC clauses are generally highly negotiated and tied to specific value impacts. Potentially, a MAC may be tied to breach of warranty or breach of a pre-completion covenant. In negotiating a MAC clause, parties will focus carefully on carve-outs relating to force majeure-type events (noting the impact of the pandemic).

Other types of conditions – for example, board/investment committee approval, shareholder approval (other than in a listed company scenario), financing or change-of-control approval in respect of material contracts are very unusual in the private equity transaction space (although they may be negotiated on a case-by-case basis).

6.5 "Hell or High Water" Undertakings

As in other jurisdictions, it is unusual in New Zealand for a private equity buyer to accept a "hell or high water" undertaking in respect of a Regulatory Condition.

This type of undertaking (most typically seen in provisions regarding antitrust) requires a buyer to take whatever steps need to be taken – which could include divestments or compliance with onerous undertakings – to ensure that the relevant regulatory approval is granted. This can be particularly difficult for a private equity fund, which is likely to have a number of different businesses across its portfolio, as to do so would potentially place it in breach of its fiduciary obligations to other investors.

In the scenario of a highly competitive bid, however, a private equity buyer may seek to strengthen its position by accepting a "hell or high water" undertaking (or something close to that) if it has had the benefit of advice and can be comfortable with that position.

If there is a known substantive issue arising in relation to the portfolio, a strategy in relation to this will generally be negotiated upfront.

It should be noted that this can be a complicated issue in the context of an OIO application, given the range of potential undertakings that may be required, particularly where sensitive land is involved; accordingly, it is vital that legal advice is taken on this point.

For the purposes of these undertakings, New Zealand's legal system continues to distinguish between merger control (enforced by the NZCC) and foreign investment conditions (enforced by the OIO).

6.6 Break Fees

Non-code Transactions

In the context of a private company acquisition, it is not usual to see break fees or costs reimbursement. There are occasional exceptions to this, however, as follows:

- a seller may agree to a break fee in the context of an exclusivity breach; or
- a seller may agree to cost coverage in the context of a competitive bid (in lieu of exclusive "preferred-bidder" status, in order to keep several bidders in the race).

However, this is relatively uncommon.

It should be noted that any arrangement in this context needs to be considered carefully in view of the unenforceability of penalty clauses. Generally, this can be dealt with as expressing the payment obligation as a reimbursement of costs, as liquidated damages or as a genuine pre-estimate of loss.

Code Transactions

In Control Transactions which are being conducted on a friendly basis (with deal protections incorporated into an Implementation Agreement or similar) it is common for the target to agree to pay a break fee in respect of any breach of key target obligations, if there is a breach by the target of key obligations (such as director recommendations, no-shop, no-talk, etc), and if the transaction does not complete.

There is no formal guidance from the Panel on this point, but New Zealand tends to follow other jurisdictions and limit any break fee to 1% of the value of the target business.

Reverse break fees are also becoming reasonably common in New Zealand – generally where there is a failure to complete because of the buyer's breach, or failure to obtain a requisite regulatory consent.

As is the case with non-Code transactions, in agreeing any break fee arrangements, consideration must be given to whether these could constitute a penalty.

6.7 Termination Rights in Acquisition Documentation

As is the case with conditionality (see **6.4 Conditionality in Acquisition Documentation**), any seller will wish to minimise any termination rights. Accordingly, termination is usually limited to failure to satisfy any condition precedent (including any MAC).

Note in this context that the buyer will usually ensure that material breach of warranty or pre-closing covenants falls within the ambit of a MAC (by way of example, insolvency). Alternatively, a specific termination right in this regard might be sought.

Outside these termination triggers, and in the absence of a material breach at closing, other termination rights are typically excluded.

The long-stop date generally depends on the nature of the transaction, what is reasonable in the circumstances and the conditions – for example whether OIO consent and/or NZCC clearance is required.

6.8 Allocation of Risk

A private equity seller in New Zealand will normally seek to minimise or exclude altogether any post-completion liability for breaches of warranties and indemnities. Accordingly, warranty and indemnity (W&I) insurance is now a common feature in any proposed transaction by a private equity seller. Private equity buyers are also generally happy to accept W&I insurance, subject to there being some "skin in the game" on the part of the seller (eg, backstop coverage for any gaps in W&I coverage).

Trade sellers may be inclined to bear more risk than their private equity counterparts, and are often more able to do so. That said, W&I insurance is being utilised by different types of sellers (including smaller-sized corporates and family-owned businesses) where there is a desire to ring-fence risk and obtain a clean exit.

Unlike some other jurisdictions, generally, members of management teams in New Zealand will not provide any warranties to the buyer in their personal capacity (unless they are also sellers, in which case they tend to provide the same warranties as the private equity seller, albeit on a limited-recourse basis, given the use of W&I).

Any matters that are known to the buyer (customarily, including those that are deemed to be known via the due diligence disclosure process) will be excluded from warranty protection – to the extent that the buyer seeks protection in respect of disclosed matters, it will need to seek specific indemnification for the matter or make an adjustment to its price.

See further in **6.9 Warranty and Indemnity Protection** and **6.10 Other Protections in Acquisition Documentation** for further details of the allocation of risk between sellers and buyers in New Zealand.

6.9 Warranty and Indemnity Protection

Private equity sellers in New Zealand will generally only directly stand behind fundamental warranties as to title and capacity. These will usually be capped based on the value of the underlying business and will be subject to a time limitation (usually two to three years).

To the extent that the buyer requires further protection in the form of business warranties, as previously noted in **6.8 Allocation of Risk**, this will usually be provided by the seller, but on the basis that the buyer's recourse is solely against the W&I insurance (and not against the seller, in the absence of fraud). The relevant policy will usually cover business warranties and an indemnity for pre-completion tax.

The policy will typically be valid for two to three years for business warranties and six to seven years for the tax indemnity.

The W&I insurer will not generally be liable for warranty claims unless the amount recoverable meets a specified threshold. The generally accepted market position (for both insured and non-insured deals) is that an individual claim must exceed 0.1% of the purchase price and the aggregate amount recoverable must exceed 1% of the purchase price (although insurers are offering de minimis and basket thresholds of 0.05% and 0.5% respectively, or "tipping" or "partial tipping" arrangements in certain circumstances, with a corresponding increase to the premium). Claims will also be subject to an overall cap (these can vary in size, depending on the overall deal size, but are typically in the range of 20 to 40% of the total consideration for the target business).

The W&I policy will contain limitations; as previously noted in **6.8 Allocation of Risk**, it will not cover matters known (or deemed to be known) to the buyer, or matters which arise in and which the buyer becomes aware of in the period between signing and closing and certain of the covered warranties will be subject to knowledge qualifiers. As per other jurisdictions, it is possible to obtain "add-ons" to a W&I policy to address these points (for example, "new breach" cover and "knowledge scrape" provisions) – however, this will generally result in a significant increase to the premium payable.

There are also a number of common exclusions in W&I policies in New Zealand (for example, price adjustment, environmental contamination issues, etc).

To the extent that specific issues are identified as a part of due diligence (by way of example, a specific litigation risk) it may be possible to obtain specific coverage from a W&I insurer in respect of that risk. However, this will be assessed on a case-by-case basis and will generally result in a significant increase in premium.

6.10 Other Protections in Acquisition Documentation

As noted above, W&I insurance is commonly used in private equity transactions in New Zealand. This would customarily cover fundamental and business warranties, and tax matters (warranties and the tax indemnity).

Having escrow or retention mechanisms in place to back the obligations of a private equity seller is not common. The exception to this would be in respect of an indemnity for a known liability (eg, specific litigation risk), and where deal dynamics warrant the seller agreeing to such a mechanism.

6.11 Commonly Litigated Provisions

Generally speaking, New Zealand is not as litigious as other jurisdictions (such as the USA), and disputes are uncommon in private equity transactions.

Disputes arising in relation to leakage under a locked-box mechanism will typically be dealt with between the parties, rather than litigated, and any issues in relation to completion accounts are typically referred to an expert.

Experience shows that the most typical categories of claims under W&I policies are in relation to warranties regarding accuracy of information disclosed, accounts and material contracts.

7. Takeovers

7.1 Public-to-Private

While not as common as private deals, public-to-private transactions are a feature of the private equity deal landscape in New Zealand and may become more frequent as private equity fund managers search for deal opportunities at an under-value in the event of an economic downturn following the COVID-19 pandemic and subsequent economic downturn.

There are two potential structures for a take-private transaction in New Zealand: (i) a contractual Takeover Offer pursuant to the terms of the Code, which may be a full or partial takeover offer; or (ii) a court-approved Scheme, which will also be subject to certain requirements under the Code.

The role of the target company and its board in both a Takeover Offer and Scheme is to provide its shareholders with a recommendation and reasoning on whether to accept or reject a Takeover Offer or whether to vote for or against a Scheme. In respect of a Takeover Offer, although approval of the target board is not necessary, a recommendation typically carries significant weight in terms of assisting shareholders to assess the relevant proposal. In a Scheme, the co-operation of the target company's board is needed for the Scheme to be put before shareholders. Therefore, the role of the target company and its board in both instances is important.

Hostile takeovers are permitted in New Zealand but are very uncommon, particularly with private equity buyers. Private equity bidders customarily wish to effect take-private transactions via a Scheme, which (as noted above) can only be facilitated in a consensual transaction.

Relationship agreements between the bidder and the target in relation to consensual deals are common in New Zealand, regardless of the method of acquisition. To increase the likelihood of a successful transaction from the outset, the bidder would customarily obtain (i) irrevocable undertakings (for a Takeover Offer) or voting undertakings (for a Scheme) from substantial shareholders; and (ii) enter into a bid implementation agreement (for a Takeover Offer) or a scheme implementation agreement (for a Scheme).

See **3.1 Primary Regulators and Regulatory Issues**, which includes a summary on the rules related to public-to-privates in New Zealand.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

The primary material shareholding-disclosure threshold and filing obligation under the NZX Listing Rules and FMCA is the "substantial product-holder" notification: persons who obtain voting power of 5% or more in an NZX-listed company must disclose this fact (as well as other details about their interests and their name and address) by filing a "substantial product-holder" notice.

In circumstances where a person's voting power exceeds 5%, a substantial-holding notice must also be filed each time the voting power increases or decreases by 1%.

7.3 Mandatory Offer Thresholds

New Zealand law prohibits the acquisition of a Control Interest (as defined in **3.1 Primary Regulators and Regulatory Issues**) in the issued voting shares in a Code Company, which would result in a person's voting power equalling or exceeding 20%. Acquisitions above this level must be effected through one of the prescribed exceptions.

7.4 Consideration

In a Code Transaction (whether transacted as a Takeover Offer or a Scheme), a bidder may offer any form of consideration, including a cash sum, securities or a combination of cash and securities (which may include "roll-over" equity in a Bidco). New Zealand does not have any minimum price rules.

7.5 Conditions in Takeovers

A Control Transaction implemented by way of a Takeover Offer will be conditional upon a minimum interest threshold – the bidder must offer to acquire a certain percentage of the shares in the target (eg, 90%, so that the target can acquire the target compulsorily, or 51%, so it has voting control).

It is common for both Takeover Offers and Schemes to include other conditions, such as regulatory conditions (NZCC and/or OIO) and a MAC condition. However, in a Takeover Offer scenario, the Panel will limit a buyer's ability to enforce conditions that are within the buyer's sole control or subjective opinion. In a Scheme context, the target is unlikely to agree to any such conditions.

See **6.6 Break Fees**, which includes the circumstances where break fees can be negotiated between the bidder and the target in both non-Code Transactions and Code Transactions.

7.6 Acquiring Less Than 100%

A bidder is able to acquire a target compulsorily if it has obtained a controlling interest in 90% or more of the voting securities in the target.

In the event that greater than 50%, but less than 100%, of the target is acquired, a private equity buyer will largely have control over the target through its ability to control the board.

However, for as long as the target remains listed, it will continue to be subject to the NZX Listing Rules which will, amongst other things, require shareholder approval for certain transactions (including related-party transactions).

A debt pushdown would constitute financial assistance which is regulated by the Companies Act 1993 and/or the NZX Listing Rules (depending on whether the company is private or listed).

7.7 Irrevocable Commitments

Pre-bid undertakings from existing shareholders, whether taking the form of irrevocable undertakings (in relation to a Takeover Offer), voting undertakings (in relation to a Scheme) or public statements of intent, are a common feature of New Zealand takeovers. These are normally obtained prior to the announcement of the Control Transaction.

Any such undertaking may, however, contain the ability for the shareholder to take advantage of any superior offer that may emerge (either absolutely or within a certain increased-value range).

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentivisation of the management team (usually by way of a management incentive plan (MIP)) is a common feature of private equity transactions in New Zealand due to the desire to ensure management retain “skin-in-the-game”. While each transaction can differ substantially, typically management will hold only a small level of equity ownership in the target, generally 5% to 15%.

8.2 Management Participation

In New Zealand, management equity generally takes the form of options or loan funded shares. Often, these will be realised via a cashless exercise mechanism in the event of an exit. Cash-funded investment by senior managers is also common.

Preferred instruments are not typically used in the management equity structures (these are generally reserved for the private equity buyer) and so management will usually be issued ordinary equity (or a separate class of equity with largely the same rights as ordinary equity).

8.3 Vesting/Leaver Provisions

New Zealand leaver provisions generally contemplate “good” and “bad” leavers consistent with other jurisdictions (eg, the United Kingdom and Australia). In most MIPs, a person will be designated a bad leaver, unless their employment is terminated without cause or they die or are incapacitated. However, customarily the board will retain a discretionary right to permit management to be designated a “good leaver” outside of the prescribed regime.

It is common for MIPs to include vesting provisions, particularly where the participants are being issued equity in the form of either options or ordinary shares. In contrast to other jurisdictions, in New Zealand it is usual for management equity to vest on issuance, however where the management equity being issued is options, typically such options will only become exercisable on an exit or on an exit where a specified value has been achieved.

8.4 Restrictions on Manager Shareholders

MIPs will normally include provisions preventing management shareholders from competing with the target's business.

Any such non-compete clauses are generally limited, geographically and temporally, typically for about 12 months post the relevant manager's exit from the business (although longer periods may be possible, depending on the nature of the transaction and the position held by the manager, as well as the size of the equity stake held by the manager). It is also common for these clauses to extend to a prohibition on soliciting key employees, suppliers and customers of the target. These clauses are generally included in both the MIP documentation and the relevant manager's employment agreement (the latter, to the extent a new contract is put in place contemporaneously with the MIP documentation).

8.5 Minority Protection for Manager Shareholders

Manager shareholders often do not have the benefit of anti-dilution protections. In certain scenarios, such as where the manager shareholders hold a significant majority stake or the management team roll over their existing vested interests in the target, the manager shareholders may be able to negotiate into the shareholders' agreement certain protections (such as veto rights over specific matters that would materially prejudice their interests (eg, amendments to the company's constituent documents)).

However, it would be very unusual for manager shareholders to have meaningful influence over a private equity owner's exit strategy/rights.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

For wholly-owned portfolio companies, the private equity owner will have complete control over the company.

For portfolio companies that would be wholly-owned by the private equity owner but for a management shareholder group and/or an employee shareholder group holding a minority stake, the private equity owner will generally have substantial control over the company (eg, majority board-appointment rights) and its control will be tempered only by certain minority veto rights set out in the shareholders' agreement as noted in **8.5 Minority Protection for Manager Shareholders**. However, typically, the private equity owner will have full visibility over every aspect of the portfolio company's business.

9.2 Shareholder Liability

In New Zealand, similar to many other jurisdictions, shareholders of a company will generally not be held liable for the company's acts and omissions.

However, the "corporate veil" may be pierced in certain, specific situations, such as:

- a person or entity using the relevant company to avoid existing legal or contractual duties, obligations or liabilities;
- the company being used as a sham or façade, masking the real purpose of the relevant corporate controller; and
- where the relevant shareholder has acted as a shadow director of the company, and therefore will be subject to the same duties and liabilities as a director of the company

(including any duties and liabilities in relation to trading while insolvent).

10. Exits

10.1 Types of Exit

In New Zealand, while transaction- and fund-specific, private equity owners typically hold investments for a period of three to six years.

Private sales (whether by way of formal sales process or a treaty/bilateral process) are the most common form of exit, although private equity-backed IPOs are seen from time to time.

Private equity sellers will often consider both a public and private exit; they will usually make a determination as to which route to pursue at a fairly early stage in the process (and so it is unusual for a true "dual-track" process to be run, whereby an IPO and sale process are run concurrently to conclusion). Potentially, a recapitalisation could be considered at the same time, but "triple-track" processes are uncommon in New Zealand.

It is becoming more common for private equity sellers to reinvest upon exit, where selling to a larger or more global private equity fund. This is typically achieved by rolling into a minority shareholding position in the new holding company, albeit often through a new fund raised by the fund manager.

10.2 Drag and Tag Rights

Almost all shareholders' agreements relating to investments majority-owned by a private equity fund will include drag rights to enable the private equity fund to sell 100% of the investment. The customary drag right threshold for a sale is 75% (assuming the cornerstone private equity fund holds this stake), but can be as low as 50.1%.

The inclusion of drag rights is commonly understood and accepted by minority shareholders (eg, management, co-investors, rolling sellers) on the basis that they understand that they are "along for the ride" and that the private equity fund must exit at some point in order to generate a return for its investors. However, in practise, drag rights are very rarely relied upon by private equity sellers, demonstrating the high level of trust and co-operation which is often developed between the private equity fund manager (and their representatives at the portfolio level) and other shareholders.

Similarly, almost all shareholders' agreements relating to investments that are majority-owned by a private equity fund will feature tag-along rights, although only exercisable where the majority private equity fund shareholder has not exercised its drag rights. These tag rights provide the minority shareholders with the right to tag-along or "piggy-back" on a sale of shares by the majority private equity fund shareholder by requiring the purchaser to buy out their minority shareholding as well. Typically, tag-along rights will only be triggered by a complete exit by the majority private equity fund shareholder, although sometimes will be capable of being triggered on a pro rata basis if a control transaction (ie, at least 50.1% of the shares) is being sold by the majority private equity fund shareholder. Notwithstanding the above, while not overly common, sometimes management incentive plans will preclude management from tagging in the event of an exit by the majority private equity fund shareholder.

Drag rights apply to all shareholders, however tag rights will generally only apply to institutional co-investors.

10.3 IPO

The COVID-19 pandemic (and resulting market disruption and uncertainty) reduced IPO activity throughout 2021 and into 2023. This remains the trend in 2024, given current market uncertainty (see further **1.2 Market Activity and Impact of Macro-Economic Factors**). The market remains cautious and there has not yet been any meaningful increase in capital markets activity.

Voluntary escrow arrangements or, in certain circumstances, mandatory escrow arrangements enforced by the NZX, are almost always a feature of exits undertaken by way of an IPO. These escrow or "lock-up" arrangements may allow for a partial release of shares from escrow after the company's results are announced, and generally will be effective for a period of 12–24 months from the listing date. Where not mandatory, investment banks advising on the IPO will typically advise that, from a pricing and marketability perspective, it is preferable for the private equity seller to agree to some form of escrow or lock-up arrangement.

Relationship agreements between the private equity seller and the target company are a typical feature to see. These relate, amongst other matters, to seats on the board of the company and information rights.

NORWAY

Law and Practice

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Wikborg Rein Advokatfirma AS is one of Norway's leading law firms. Headquartered in Oslo, the firm has offices in Bergen, Stavanger, London, Singapore and Shanghai. Its private equity team advises major Norwegian and international private equity and venture capital funds, managers and investors, across all phases and aspects of a private equity fund's life cycle, including fund structuring and establishment, mergers and acquisitions, public-to-private transactions, auctions, restructurings, and exit strategies. The firm has provided assistance to a number of leading private equity companies, including KKR, General Atlantic, Nordic Capital, FSN Capital, Altor, Summa Equity, Apax, EQT, Antin Infrastructure Partners, in addition to numerous secondary transactions for the largest private equity fund-of-fund managers in Norway.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

2023 Activity

The 2023 Norwegian M&A market rebounded strongly after a very challenging 2022. The first half of 2023 was relatively robust, with nearly 500 transactions registered with Mergermarket, followed by almost 430 transactions in the second half. Despite the challenges of 2022, including rising inflation and geopolitical unrest, 2023 saw improved sentiment and sustained M&A activity, despite tight monetary policies and ongoing geopolitical uncertainty. There was a notable increase in foreign buyers and domestic activity, with the highest sector activity in TMT and AM&M, and increased activity in oil and gas, especially in the first half of 2023.

In contrast, equity capital markets struggled. IPO activity decreased in 2023, with only ten IPOs/listings (six on Euronext Growth), compared to 33 IPO/listings in 2022 (15 on Euronext Growth).

2023 deal activity was dominated by technology (18%), services (business support services, consulting services, engineering services, etc) (14%), energy (10%) and the construction sector (10%).

2024 Activity

The Norwegian M&A market has maintained robust activity levels in 2024, with transaction volumes almost matching the first half of the previous year. Over 200 transactions were registered with Mergermarket in both quarters, though Q2 saw a decline in deal activity of approximately 15%.

As for 2023, sector activity was driven by TMT and AM&M. Domestic activity remained steady, with a slight decrease in foreign buyers and likewise a small uptick in outbound transactions.

Equity capital markets have struggled in 2024 due to unfavourable market conditions and lower investor appetite. The first half of 2024 saw only seven IPOs/listings (three on Euronext Growth), mirroring the first half of 2023.

Private M&A activity in Norway is expected to remain relatively strong, owing to the resilient Nordic and Norwegian economies, intraregional activity, an optimistic deal pipeline, and sufficient capital available on the financing and equity markets. These factors make Norway and the Nordic region currently among the safest investment regions in the world. Norwegian businesses are likely to continue attracting significant interest from US and European private equity investors.

1.2 Market Activity and Impact of Macro-Economic Factors

According to Mergermarket, approximately 70% of the deals made in the last 12 months (LTM) were private, as opposed to public deals.

The Norwegian private equity market features all types of transactions found in mature global markets. Historically, deals involving the oil and gas and supply industries have been significant. While the recent decline in oil prices and the green shift have dampened the deal activity within this sector, the stabilisation of oil prices amid geopolitical turmoil in Europe has increased demand for fossil fuels. As a result, deal activity within the oil and gas industry, and, in the near future, deals in the supply industry, will likely increase.

The Norwegian market continues to be significantly affected by cross-border transactions, of which two-thirds have a cross-border element historically. In 2023 and so far in 2024 we have seen an increase in domestic transactions, and for some months reaching almost a 50/50 split between domestic and transactions with a cross-border element. Also, looking at inbound and outbound cross-border transactions, historically we have seen a consistently higher average of inbound transactions (foreign companies buying Norwegian targets) compared to outbound transactions (Norwegian companies buying foreign targets), but in Q2 2023 we saw a higher number of inbound transactions than outbound.

Companies with high environmental, social, and governance (ESG) scores are more active across industries. M&As are increasingly influenced by ESG considerations, affecting target selection, due diligence, valuation, financing and post-closing integration and governance. EU regulations, including the Sustainable Finance Disclosure Regulation, heighten the importance of ESG. The Norwegian Government Pension Fund continues to accelerate divestments from companies with high sustainability risks and enforcing transitions towards net zero, while the Norwegian government has set clear ESG expectations for state-owned companies, as outlined in the White Paper “Meld. St. 6 (2022-2023)”.

The economic uncertainty over the past years has misaligned buyer and seller expectations, with sellers still expecting historical price levels. However, this gap seems to be closing.

The global private equity market’s record high exit backlog has affected the Norwegian market, with a relatively modest exit space in recent years. With stabilising inflation and interest rates, a weak Norwegian krone (providing international investors considerable discounts), and the high exit backlog, the number of private equity deals in Norway is expected to continue to improve in the second half of the year and into 2025. Historically, most exits have taken the form of trade sales to industrial investors or secondary sales to other private equity funds, rather than IPOs.

In the last few years, we have seen a significant rise in continuation vehicles in the market (including among Norwegian fund managers), also adding a new dynamic to the secondary market. These vehicles have evolved into strategic tools for creating liquidity for existing limited partners and ensuring timely returns. Continuation vehicles offer an alternative to forced exits, allowing fund managers to extend the holding period of high-potential assets. This approach maintains stability in portfolio companies and aligns with the investment horizons of LPs, who typically can elect to roll over or exit. Given the current market dynamics, continuation vehicles

are expected to remain prominent and continue evolving, offering flexibility and strategic options that enhance the resilience and adaptability of private equity funds.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Ownership in Bank or Life Insurance Company

Norway has a long-standing administrative practice that restricts any single shareholder from owning more than 20–25% of a Norwegian bank or life insurance company (or financial groups comprising such entities), unless the shareholder is itself a financial institution.

On 11 July 2024, the European Free Trade Association Surveillance Authority (ESA) decided to take Norway to the EFTA Court over domestic law and administrative practice regarding the ownership ceiling practice. ESA holds that the practice violates the EEA Agreement that exists between Norway and the EU. Norway has adopted amendments to the Financial Institutions Act effective from 1 July 2024, but the ownership ceiling practice is maintained. The Ministry of Finance has also tasked the FSAN with reviewing the ownership control framework; however, with expectations that the FSAN will propose maintaining the ownership practice unless the EFTA Court orders the practice to be unlawful under the EEA Agreement.

Should ESA's stance be validated by the EFTA Court, it could pave the way for full acquisitions of various Norwegian financial institutions. This includes potential buyouts by private equity funds, contingent upon relevant regulatory bodies deeming such entities fit for qualified ownership stakes.

Withholding Tax on Liquidation Proceeds for Foreign Shareholders

Under the current Norwegian tax regime, liquidation proceeds distributed from a Norwegian entity are not taxable for foreign shareholders (unless the shares are owned as part of a taxable business in Norway). An expert committee appointed by the Norwegian government has proposed to introduce withholding tax on liquidation proceeds to foreign shareholders. It is not clear if and when such rules will be introduced, but if the rules are introduced they will have an effect on the level of taxation when exiting investments in Norway through liquidation. However, certain exemptions are expected for corporate shareholders resident within the EEA.

EU Directives and Regulations

In order to comply with its obligations under the EEA Agreement, Norway must adopt and implement certain EU Directives and Regulations. On 11 June 2024, the Norwegian Parliament adopted a new PRIIPs Act, implementing Regulation (EU) No 1286/2014 (PRIIPs), which has been in force in the EU since 2018. The Norwegian act is expected to enter into force later in 2024.

The new PRIIPs Act also implements Regulation (EU) 2019/1156 on facilitating cross-border distribution of collective investment undertakings (CBDF), which has been in force in the EU since 2019. CBDF is linked to the entry into force of PRIIPs, meaning both will become effective simultaneously.

To address the shortcomings of ELTIF 1.0, "ELTIF 2.0" was adopted by the EU on 10 January 2024. The implementation date in Norway remains uncertain.

The AIFMD II entered into force in the EU on 15 April 2024. AIFMD II includes a regulatory framework governing credit funds, which represents a significant development by allowing direct lending funds access to the Norwegian market. AIFMD II sets a transposition deadline two years after the EU implementation date, and it remains to be seen whether Norway will implement it within this timeframe.

The EU sustainable finance framework has had a notable impact on private equity funds and transactions, also in Norway. The implementation of the EU Taxonomy Regulation and the EU Sustainable Finance Disclosure Regulation (SFDR) in Norway in early 2023 has contributed to driving the focus and importance of ESG considerations for private equity funds. The objective of the SFDR is to provide transparency to investors about the sustainability risks that can affect the value of their investments and about the adverse impacts such investments have on the environment and society with a view to supporting EU climate and sustainability neutral targets, with the results that ESG considerations now play a more significant role in shaping private equity funds' investment choices and exercising of active ownership. The implementation of the EU Corporate Sustainability Reporting Directive into Norwegian legislation, which takes effect from 1 January 2025, is poised to further strengthen this trend.

In April 2024, the European Parliament adopted the EU Listing Act, introducing amendments to the EU Prospectus Regulation, the EU Market Abuse Regulation and the EU Directive and MiFID II and MiFIR. The EU Listing Act aims to facilitate the listing for companies of all sizes, including SMEs, and reduce post-listing requirements. The amendments to the Prospectus Regulation are expected to take effect in Norway in the first half of 2025, pending the completion of the EU legislative process. The timing for implementing other aspects of the EU Listing Act in Norway remains uncertain.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

General

Most Norwegian private equity transactions involve limited companies. Thus, the main company-specific acts that regulate M&A transactions are the Private Limited Companies Act and the Public Limited Companies Act. Depending on the deal in question, other general legislation supplements the aforementioned, mainly the Contracts Act, the Sale of Goods Act, the Accounting Act, the Taxation Act, the Employment Act and the Competition Act.

Listed Targets

The regulatory framework differs significantly for listed and non-listed targets. In respect of non-listed targets, the parties are largely free to agree on the terms of the sale and transaction agreements. For targets listed on the regulated markets (Euronext Oslo Børs and Euronext Expand), the Securities Trading Act and the Securities Trading Regulations (supplemented by rules and guidelines issued by Euronext Oslo Børs) provide a comprehensive and mandatory set of rules. These rules do not apply to targets listed on Euronext Growth (non-regulated market), yet market practice suggests that such acquisitions to a large extent are structured similarly to acquisitions of listed targets, despite no equivalent set of mandatory regulations.

Norway has implemented (with some exceptions), inter alia, the EU Prospectus Regulation,

the Market Abuse Regulation, the Markets in Financial Instruments Directive, the Markets in Financial Instruments Regulation, the Takeover Directive and the Transparency Directive. These rules contain, inter alia, offer obligations and disclosure obligations that dictate the sales process for companies listed on regulated markets; see **7. Takeovers**.

Government Ownership and Control

The Norwegian government is a major owner in the Norwegian economy through significant holdings in many listed companies, and non-listed entities through investment companies such as Argentum, Investinor and Nysnø Klimainvesteringer. Through two government pension funds, the Government Pension Fund Norway (GPFN) and the Government Pension Fund Global (GPFG), the government invests heavily in foreign and domestic companies. In some areas, such as the retail sale of alcohol, the government retains a monopoly.

AIF

Norway has implemented the EU Alternative Investment Fund Manager Directive (AIFMD) through the Norwegian Act on the Management of Alternative Investment Funds (the AIF Act). The AIF Act applies to managers (AIFMs) of alternative investment funds (AIF). Private equity funds generally fall under this definition. Generally, AIFMs are required to be authorised. However, certain exemptions apply to so-called sub-threshold AIFMs, which may register with the FSAN and only be subject to the AML regime and certain disclosure obligations. To qualify as a sub-threshold AIFM, the AIFM cannot manage AIFs with aggregated assets under management equal to or exceeding an amount equivalent in NOK to:

- EUR500 million, when the portfolios comprise unleveraged AIFs with no redemption rights exercisable during a five-year period following the initial investment; or
- EUR100 million, for AIFs other than those mentioned above.

Sub-threshold AIFMs cannot market their AIFs to retail investors in Norway, nor passport their services into other EEA member states.

The FSAN supervises licensed and registered AIFMs in Norway.

Acquisition of Control

Notification requirements apply to the acquisition of control of listed companies and non-listed companies of a certain size. In addition, if an AIF's voting share of non-listed companies reaches, exceeds or falls below 10%, 20%, 30%, 50% or 75%, the AIFM must notify the FSAN as soon as possible (at the latest within ten business days).

AIFs are also subject to the asset stripping provisions under the AIFMD/AIF Act, meaning that there are limitations on distributions, capital reductions, share redemptions and acquisition of own shares by EU-incorporated portfolio companies during the first two years following acquisition of control by an AIF, individually or jointly together with other AIFs.

There are other provisions of the AIF Act that also apply, but the aforementioned often impact private equity funds.

Merger Control

In accordance with Norwegian merger regulations, companies must notify the Norwegian Competition Authority (NCA) of concentrations where the combined Norwegian annual turnover

of the undertakings concerned exceeds NOK1 billion and at least two of the undertakings concerned have an annual Norwegian turnover exceeding NOK100 million.

Transactions triggering a notification cannot be closed until they have received clearance from the NCA.

The NCA may also, within three months of a final agreement/acquisition of control, call in for review transactions falling below the turnover thresholds if the NCA has reason to assume that competition will be affected. It is also possible to voluntarily notify the NCA of a transaction, although this is rarely done.

No notification is required to the NCA if the parties meet the thresholds for a mandatory notification to the European Commission under the EU Merger Regulation, or if they need to make a notification to the EFTA Surveillance Authority.

Foreign Direct Investment

The current Security Act (SA) provides that entities handling classified information, controlling information, information systems, objects or infrastructure that are of vital importance to fundamental national functions, and/or engaging in activities that are of vital importance to fundamental national functions, shall be designated as subject to the SA. Then, where at least one-third of the shares in that company are subject to an acquisition, whether by a Norwegian or foreign acquirer, the acquirer must notify the relevant ministry or National Security Authority about the transaction.

In addition, entities providing goods/services of significant importance to fundamental national functions or national security interests may be made subject to the SA. In either case, the relevant provisions of the SA only apply where the target entity has been designated as being subject to the SA by formal decision. There is currently no public register of entities that have been designated, and so an acquirer must ask about designation during due diligence.

A number of changes to the SA have been proposed, but are not in force yet. These changes include: (i) a standstill obligation, preventing the closing of an acquisition until the relevant ministry has provided its approval for the investment; and (ii) a lowering of the threshold for when a notification is required, to a ten percent stake, with recurring filing obligations arising when the ownership stake passes one-third, fifty percent, two-thirds and ninety percent.

The EU Foreign Subsidies Regulation

The EU Foreign Subsidies Regulation does not apply to purely Norwegian transactions, unless the target also operates in EU. The relevant thresholds are:

- the acquired company, one of the merging parties, or the joint venture must generate turnover (on group level) in the EU of at least EUR500 million; and
- the parties to the transaction must have been granted combined aggregate foreign financial contributions of at least EUR50 million over the past three years.

The European Commission takes the view that foreign contributions received from the Norwegian government are relevant for determining whether the latter threshold is met. Where the thresholds are met, notification must be made to the Commission. The Foreign Subsidies Regulation has been relevant in large-scale Norwegian transactions since coming into force, for exam-

ple Permira's and Blackstone's offer for the outstanding shares in Adevinta.

Anti-bribery, Sanctions and ESG

The regulatory landscape is still influenced by the sanctions against Russia and Russian nationals by Norway, the EU, the UK and the USA, as well as Russian countermeasures to those sanctions. In the last year we have seen more focus from regulators on circumvention risks, and a surge of measures and countermeasures continues to impact the attention bidders pay to sanctions and export control issues during due diligence.

The Norwegian Act relating to enterprises' transparency and work on fundamental human rights and decent working conditions (Transparency Act) entered into force on 1 July 2022, and intends to promote companies' respect for fundamental human rights and decent working conditions in their own operations and in their supply chains and business partners. With the adoption of the Corporate Sustainability Due Diligence Directive (CSDDD) in the EU, the scope of the due diligence obligation will be broadened, as the CSDDD covers environmental impacts in addition to human rights and labour rights. This directive will be transposed into Norwegian law, possibly through a revision of the Transparency Act.

Non-compliance with the Transparency Act and the CSDDD could lead to enforcement or infringement penalties, and it is expected that Norwegian authorities' control and enforcement will increase going forward. With the Corporate Sustainability Reporting Directive (CSRD) entering into force, companies are required to provide detailed sustainability disclosures, including environmental, social and governance (ESG) data. They must ensure transparency in their reporting processes and verify the accuracy of their information through independent audits. The main risks for companies include potential legal penalties for non-compliance and reputational damage from inadequate or misleading reporting. Additionally, failure to meet CSRD requirements can result in diminished investor confidence and increased scrutiny from stakeholders.

4. Due Diligence

4.1 General Information

In the Norwegian market, buy-side due diligence is typically red flag-focused. In structured sales processes, where sell-side requests vendor due diligence (VDD), a more detailed VDD is often conducted, particularly regarding financials.

Due diligence is normally conducted by a legal, financial and tax team. Sometimes, separate teams are engaged for other key areas depending on the transaction, and we are seeing increasing use of ESG due diligence advisers. Other than business-specific issues, key areas of focus for legal due diligence in private equity transactions include:

- corporate;
- GDPR;
- anti-trust;
- anti-corruption;
- environmental, social and governance (ESG); and
- regulatory matters.

There has been an increase in focus on ESG, anti-corruption, and trade sanctions for target groups operating in high-risk jurisdictions, in particular due to the Russian-Ukrainian war and related sanctions.

As AI tools are advancing rapidly and testing and integration into due diligence processes accelerate, there are still several challenges that hinder full implementation into Norwegian processes (eg, legal complexity, language and nuance), keeping them in a trial phase. While AI tools can process vast amounts of data, enhancing efficiency and accuracy to provide early crucial insights, we expect these tools to be complementary to legal advisers in due diligence processes rather than fully replace them.

4.2 Vendor Due Diligence

VDD is common for private equity sellers in structured sales processes. Conducting a VDD helps in identifying and addressing any material findings before the transaction commences. Presenting a VDD report to potential bidders gives them detailed information early, enabling informed offers within tight timeframes and providing some level of comfort related to the target's business.

In Norway, VDD reports typically take the form of traditional issue-based reports or more descriptive fact books of the target group. Such reports are normally provided by sell-side legal advisers in structured sales processes.

When VDD reports are available, advisers often rely on them and conduct buy-side due diligence on a confirmatory or "top-up" basis (ie, to verify or further explore the VDD findings).

The final buyer and finance provider are often offered VDD reports for reliance.

5. Structure of Transactions

5.1 Structure of the Acquisition

Private equity funds in Norway typically acquire companies through share purchase agreements as well as shareholder agreements applicable to joint investments by the fund, any co-investors, and management shareholders. Prior to negotiating long forms, the parties typically enter into a term sheet and non-disclosure agreement.

Compared to auction sales, the terms of the acquisition in privately negotiated transactions are generally quite similar. In auction sales, the transaction agreement typically contains fewer conditions precedent as bidders will use this as a tool to make their bid more appealing to the sellers.

In public deals, to reduce transaction risk, the acquisition is often carried out by material shareholders and members of the management and board owning target shares agreeing to pre-accept the offer, followed by a public offer. A transaction agreement entered into by the bidder and the target board setting out the terms and conditions for the offer is the norm for friendly takeovers in the Norwegian market, where, inter alia, the board pre-agrees to recommend the target's shareholders to accept the offer. Close to 75% of all voluntary tender offers approved by Euronext Oslo Børs from 2008 to July 2024 (completed and uncompleted) were made on this basis. If the bidder is unable to achieve 100% control through a voluntary tender offer, the bidder may, on certain conditions, opt for a squeeze-out; see **7.6 Acquiring Less than 100%**.

5.2 Structure of the Buyer

In Norwegian acquisitions the private equity-backed buyer entity (acquisition vehicle) is

almost exclusively structured as a Norwegian private limited company (*aksjeselskap*), set up as a single purpose vehicle (SPV) for the transaction (BidCo). Foreign funds with foreign managers also often invest in the BidCo structures through separate holding structure in, for example, Luxembourg or the UK.

Depending, inter alia, on the transaction financing model and other commercial factors, the Norwegian acquisition structure usually consists of either only BidCo or also a set of holding companies (MidCo and/or TopCo).

If organised under Nordic law, a one-tier structure is normally applied where the investment is made by the limited partnership through a set of Norwegian holding companies.

The choice of acquisition structure is usually determined by which structure would allow for the most efficient return on investment upon exit. This depends – in addition to tax efficiency in respect of the acquisition, duration of investment and exit (such as rules on deductibility of interest, withholding tax, VAT and thin capitalisation) – on a number of factors, including financing, governance structure, the existence of co-investors, risk exposure, corporate liability, disclosure concerns, and regulatory requirements. Normally, if external financing is obtained, a structure that provides a single point of enforcement of the pledge of shares in BidCo for the finance provider is applied (eg, a BidCo, MidCo and/or TopCo structure).

The private equity fund itself is rarely involved in the documentation of the transactions (save for execution of equity commitment letters to confirm that the BidCo structures will receive necessary funding to consummate the transactions). Most often, the designated investment team and in-house legal counsel of the fund manager are involved, particularly in the initial stages of negotiation, but outside legal counsel normally leads the process. Larger deals and add-on acquisitions require the investment team to rely to a great extent on outside legal counsel.

5.3 Funding Structure of Private Equity Transactions

General Trends

In Norway, private equity deals are normally financed by a combination of third-party debt financing and equity, with the equity portion increasing in recent years, particularly in highly leveraged deals. The proportion of debt varies based on factors such as the fund's track record, deal size and robustness, the credit risk, business sector, relationship with debt providers, and the target group's future prospects of creating revenues, profits and debt service capacity. Generally, initial leverage rarely exceeds 40-50% in the current market.

Additionally, bond issues and direct lending have become more prominent in the capital structure (either replacing bank debt or in pari passu or super-senior structures). This shift is driven by increased awareness among domestic and foreign investors of the benefits of the Norwegian bond market and the structuring of direct lending within a Norwegian legal framework.

Leveraged Buyouts

In leveraged buyouts, debt financing is generally provided to the acquiring entity (BidCo) to finance the acquisition, and sometimes also to the target group to refinance existing debt and finance general corporate or working capital requirements. Typically, debt providers will not accept co-investors or management investing directly in BidCo due to their requirement for a single point of enforcement in connection with

a pledge of shares in BidCo, which is one of the reasons why there is usually a holding company above BidCo.

Acquisition Debt

Term loans, bonds or direct lending are commonly used to finance acquisition debt as well as refinance the target group's existing debt. Generally, the group's working capital and corporate financing requirements are met through working capital facilities, such as revolving credit or overdraft facilities, which are often structured as senior debt. Any sponsor equity financing is often structured as equity and/or subordinated debt.

Provision of Funds

A private limited company may, under certain conditions, provide funds, guarantees or security for acquiring its own shares or shares in the company's direct or indirect parent company.

Thus, both BidCo's acquisition debt and the target group's refinancing debt can be secured by pledging BidCo's shares and its shares in the target, along with guarantees and security from the target group.

Banks and other lenders now require fewer financial covenants, though they remain more extensive in Norway than in, for example, the London market. The leverage ratio covenant is almost always required, often supplemented by either the interest cover ratio covenant, cashflow cover ratio covenant or an equity-based covenant – while the capital expenditure (capex) covenant is rare.

Banks show greater flexibility on other covenants, like acquisition restrictions and asset sales, but are still stricter than the London market. Bond issues often include incurrence covenants and the most used covenant in these tests is the leverage ratio covenants, but we are now also seeing an increasing presence of financial maintenance covenants, in the form of leverage ratio or minimum liquidity covenants.

It is not uncommon for sellers to require an equity commitment letter to provide contractual certainty for the equity-funded portion of the purchase price from a private equity-backed buyer. Similarly, to avoid any financing conditions and ensure debt funding certainty, private equity funds frequently obtain debt commitment letters from banks and direct lenders on a "certain funds" basis before bidding or signing acquisition agreements.

In most Norwegian private equity deals, the fund holds a majority stake. Acquiring minority stakes in listed companies has occasionally occurred in recent years, but it remains rare.

5.4 Multiple Investors

Club deals involving a consortium of private equity sponsors are rare in Norway, largely because deal value does not necessitate risk distribution across other private equity funds – a strategy often used to avoid exceeding investment concentration limits or similar restrictions.

Co-investments by other investors alongside the fund (including external investors and existing limited partners) are, however, quite common. These investments are usually passive, with no direct involvement from the co-investors in the companies.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Primary Consideration Structures

Locked-box accounts are the predominant consideration structure in Norwegian private equity transactions. In auction processes, locked-box accounts are by far the most common, as they simplify bid comparisons for sellers. These accounts are usually audited (at least partially) and typically covered by a warranty.

Completion account mechanisms are also used, where the preliminary purchase price is based on an estimate of the completion accounts balance sheet, and subject to a "true-up" adjustment post-transaction to reflect the final agreed values. The final completion accounts are rarely audited.

A fixed purchase price is sometimes applied. Deferred considerations such as earn-outs are commonly offered by private equity-backed buyers, unlike private equity-backed sellers, who require a clean exit. Earn-outs are sometimes used to bridge gaps in purchase price negotiations. A private equity-backed buyer may, more often than industrial buyers, offer earn-out or other forms of deferred consideration, especially when investing in start-ups (or other companies where valuation are based on future earnings). They will often require selling management members to re-invest a substantial portion of their proceeds, settled via sellers' credits rather than cash. Security for deferred consideration is rarely provided by private equity-backed buyers, although certain operational undertakings related to earn-outs may be negotiated.

Escrow

Use of escrow arrangements is rare in the Norwegian market and private equity deals, regardless of whether the seller or buyer is a private equity player – primarily because most private equity deals now include warranty and indemnity (W&I) insurance.

Leakage Provisions

Whenever locked box accounts are applied, leakage provisions are usually also included, regardless of whether the seller is backed by a private equity firm (although leakage provisions may be more refined in private equity deals).

In a completion accounts mechanism the post-transaction "true-up" adjustment will adjust for relevant leakage.

6.2 Locked-Box Consideration Structures

Locked-box consideration structures are commonly used in Norwegian private equity transactions. Interest on the locked-box amount is normally applied and predominantly in auction processes, usually in the range between 2–5%, depending on, inter alia, the cash flow of the target group in the relevant period.

Leakage occurring during the locked-box period is usually not charged with interest.

6.3 Dispute Resolution for Consideration Structures

Separate dispute resolution mechanisms for locked-box consideration structures are not common. For completion accounts structures, a separate dispute resolution mechanism is almost always used to resolve disagreements.

6.4 Conditionality in Acquisition Documentation

In private equity transactions, conditions precedent relating to regulatory approvals, such as no intervention by the NCA or FDI, are always included (if relevant). Other typical conditions precedent include:

- no material breach occurring in the period between signing and closing; and
- due diligence-specific findings, such as key third-party consents.

Material adverse change clauses (MACs) are sometimes included in private deals, but their use has declined significantly in recent years. In public takeovers, MACs are usually included; in the period 2008–2023, 81 out of 96 voluntary offer documents approved by the Euronext Oslo Børs contained a MAC.

Transaction agreements for W&I-insured deals not subject to an auction process sometimes include a right for the buyer to terminate the agreement if new circumstances arise during the period between signing and closing which are not covered by the W&I insurance, unless the seller compensates the buyer for any downside.

6.5 "Hell or High Water" Undertakings

It is highly unusual for private equity-backed buyers to accept "hell or high water" undertakings to assume all of the antitrust or other regulatory risks related to the completion of the transaction. Typically, the buyer can walk away from the transaction if merger control approval, FSR or FDI clearance is not obtained.

6.6 Break Fees

In conditional deals with a private equity-backed buyer, a break fee in favour of the seller is uncommon. For public deals, out of 97 voluntary offer documents approved by the Oslo Børs in the period from 2008 to July 2024, 57 involved a transaction agreement, of which 29 contained provisions for break fees.

There are no specific legal limits on break fees if applied to the sellers in private and public deals. However, Norwegian company law is not entirely clear as to the extent to which the target can pay a break fee. According to the Norwegian Corporate Governance Code – particularly relevant for listed companies – the target should be cautious of undertaking break-fee liabilities, and any fee should not exceed the costs incurred by the bidder. The market level of break fees is usually in the range of 0.8% to 2% of the transaction value.

Norwegian private equity deals rarely use reverse break fees.

6.7 Termination Rights in Acquisition Documentation

In private equity deals the acquisition agreement can be terminated if conditions precedent are not met or waived within the agreed long-stop date. Termination rights are otherwise limited, with certain exceptions under Norwegian background law for cases like fraud, gross negligence or wilful misconduct, which are highly unusual.

Long stop dates vary, but typically reflect the expected time for obtaining regulatory approvals, plus a buffer of one to several months.

6.8 Allocation of Risk

In Norwegian private equity transactions, a private equity-backed seller (or buyer) is hesitant to accept any deal risk and usually requires a clean exit. Such seller usually opposes accepting indemnities. To mitigate risk the warranty catalogue is usually covered under W&I insur-

ance. If the deal is not insured, which is rare for private equity-backed sellers, they generally only offer fundamental warranties. In contrast, industrial sellers tend to provide more comprehensive warranties, regardless of insurance coverage. In auction processes, the number of conditions precedent is usually limited to no material breach, regulatory approvals and necessary third-party consents.

The main limitations on liability for the seller are linked to the buyer's knowledge, financial thresholds (basket, de minimis and total cap) and time limitations; see **6.9 Warranty and Indemnity Protection**.

6.9 Warranty and Indemnity Protection

With W&I insurance becoming the norm in private equity deals, warranties provided by private equity-backed sellers are usually comprehensive. This does not significantly differ where the buyer is also private equity-backed.

The following are the customary financial limits on warranty liability:

- de minimis: 0.1–0.2%;
- basket: 1–2% of purchase price; and
- total cap: 10–30% of purchase price.

In W&I-insured deals, the de minimis threshold is usually closer to 0.1%, and the basket closer to 1%. A private equity-backed seller will usually not accept a total cap of more than 10–15% unless the deal is W&I-insured; in this case, no recourse against the seller will apply.

The following are the customary time limits on warranty liability:

- general limitation period: between 12 and 18 months (24 months in case of W&I insurance);
- tax warranty limitation period: five years (seven years in case of W&I insurance); and
- fundamental warranties: three to five years.

Management co-investors are usually obligated under the existing shareholders' agreement to provide the same warranties as the fund (usually the same liability limitations as set out above).

Full disclosure of the data room is typically allowed against the warranties, meaning that the buyer is considered to have knowledge of information presented fairly in the provided information. Exceptions are often accepted for fundamental warranties.

6.10 Other Protections in Acquisition Documentation

The following protections are typically included in acquisition documentation:

- pre-completion undertakings by the sell-side to secure continuation of the operation of the target group in accordance with past practice and to forbid share issues and similar between signing and closing; and
- post-completion obligations such as non-compete and non-solicitation undertakings; however, private equity-backed sellers very rarely accept non-compete or non-solicit undertakings.

To secure clean exits private equity-backed sellers typically avoid providing indemnities to buyers. Management co-investors and non-private equity sellers may sometimes provide indemnities, but they are typically treated similarly to private equity sellers.

W&I insurance is very common in private equity deals, with approximately 70% of the insured deals involving private equity players. W&I insur-

ance is becoming increasingly popular for industrial players too.

For public deals, W&I insurance brokers report an increased use of W&I insurance where warranties are provided.

Escrow arrangements for a private equity seller are unusual because they conflict with the sponsor's preference for a clean exit.

6.11 Commonly Litigated Provisions

Litigation is not a common outcome of Norwegian private equity transactions. The most common cause for litigation is a breach of warranty.

With the rise in W&I insurance claims, we are seeing an increase in disputes related to completion accounts. These are often resolved outside of court through settlement agreements or expert decisions.

7. Takeovers

7.1 Public-to-Private

The majority of public-to-private transactions in Norway are completed by industrial buyers rather than private equity buyers. However, there are several successful examples of private equity public-to-private transactions (such as the acquisition of Adevinta by a bidder consortium comprising, inter alia, Permira and Blackstone (2024), KKR's acquisition of Quantafuel (2023), and Altor and Marlin's acquisition of Meltwater N.V. (2023)), indicating a general expectation in the Norwegian market that the number of private equity-backed public-to-private transactions may continue to increase in the future, also considering the significant number of IPOs during 2020 and 2021.

Once a target listed on a regulated market is made aware that an offer (mandatory or voluntary) for the shares will be made, the target's board and CEO become subject to certain corporate action restrictions, and the board is required to make a statement with respect to the offer and its consequences for the target's shareholders.

A transaction agreement is often entered into between the target's board and the bidder in a friendly process. Such agreements are also common in deals involving Euronext Growth-listed targets.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Stakeholders in Norwegian companies listed on a regulated market are subject to disclosure obligations to the issuer and Euronext Oslo Børs if the proportion of shares and/or right to shares of a person or entity reaches, exceeds or falls below any of the following thresholds: 5%, 10%, 15%, 20%, 25%, one-third, 50%, two-thirds and 90% of the total issued share capital or voting rights of the listed company. The disclosure obligation also applies to equity certificates and depositary receipts (if Norway is the home member state of the issuer), entitlements to acquire shares, and financial instruments with similar economic effect as shares.

For non-Norwegian listed on a regulated market in Norway, the thresholds are determined in accordance with the applicable law in the respective company's country of incorporation.

7.3 Mandatory Offer Thresholds

If a person, through acquisition, becomes the owner of more than one-third of the voting rights of a Norwegian company listed on a Norwegian-regulated market, the person is obligated to bid

on the remaining shares (with a repeat trigger upon reaching 40% and 50% of the voting rights). The threshold is calculated on a consolidated basis with the respective shareholders' closely associated persons (may include target shares held by affiliated or related funds or portfolio companies).

For non-Norwegian companies with a registered office within another EEA country admitted to trading on a Norwegian regulated market, the threshold depends on the laws of the country of incorporation of the company.

7.4 Consideration

The most common form of consideration in Norwegian takeovers is cash. It is estimated that approximately 80% of completed voluntary offers are cash offers, while the remaining 20% comprise shares or a mix of shares and cash. Securities such as convertible bonds, warrants, and similar instruments are also permitted, but are rarely offered. We do see takeovers that include a roll-over structure, which may be available if agreed outside the offer (prior to entering into the transaction agreement) and the voluntary offer reflects the financial value of the consideration agreed outside the offer.

Mandatory offers must at minimum equal the highest price paid in the previous six months. Mandatory offers require a full cash consideration option. However, shares or other securities may constitute alternative consideration.

7.5 Conditions in Takeovers

The most successful takeover offers in Norway are structured as a friendly offer where the bidder and the target board enter into a transaction agreement. Out of 97 voluntary tender offers between 2008 and July 2024, 80 offers (both completed and non-completed) were recommended by the target board, of which 57 involved a transaction agreement.

Norwegian takeover regulations allow for a wide range of conditions in voluntary takeover offers, such as those relating to financing and due diligence, although such conditions are likely to not be accepted by the target's board and key shareholders. Mandatory offers must be unconditional.

Common conditions for launching the offer include obtaining pre-acceptance from key shareholders and board members, maintaining the target board's recommendation of the offer, ensuring ordinary business conduct, addressing MAC, obtaining necessary regulatory and corporate approvals and achieving a specified acceptance rate (often set at 90% to facilitate the subsequent squeeze-out – see **7.6 Acquiring Less Than 100%**).

As part of a voluntary offer, a bidder may also request deal security measures such as no-shop/non-solicitation. In the event of a superior offer, the target's board normally retains the option of withdrawing or amending its recommendation. It is permissible to charge break fees up to a certain level; see **6.6 Break Fees**.

7.6 Acquiring Less Than 100%

If an offer closes with less than 90% acceptance rate, repeated mandatory offer obligations may apply (see **7.3 Mandatory Offer Thresholds**), but no additional governance rights beyond those triggered by the level of shareholding are granted.

Effective control of a Norwegian company's operations and dividend levels is achieved through board control which is achieved at more than 50% of the votes cast. Effective control over new

share issues, capital structure changes, mergers and de-mergers is achieved at two-thirds of the votes cast.

A bidder can squeeze out remaining shareholders if the bidder successfully acquires 90% or more of the target shares. A squeeze-out procedure usually takes one or two business days, with the consideration, as the general rule, being the cash equivalent in NOK of the tender offer price.

Debt pushdown is usually facilitated through dividend payments from the target being resolved after the bidder has conducted a squeeze-out and acquired 100% of the shares in the target.

7.7 Irrevocable Commitments

It is common for the principal shareholder(s) to obtain irrevocable commitments to tender and/or vote if the bid premium is acceptable. These agreements are usually negotiated shortly before the announcement of an offer from a selected group of shareholders.

Undertakings usually provide the shareholder with the opportunity to withdraw if a superior offer is made. It is possible, however, to obtain unconditional undertakings if the principal shareholder(s) believes the offer is attractive.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

In Norway, equity incentivisation of management is a common feature of private equity transactions, to ensure that the interests of portfolio companies' senior management or key personnel align with those of the private equity fund, motivating them to create further value and maximise returns on successful exits.

The size of management's investment varies depending on whether they are rolling over existing shares or injecting new capital. Management must have capital at risk in order to achieve a tax-efficient structure and typically subscribes at the same price as the private equity sponsor, although with different allocations of preference shares and ordinary shares. Selling members of management are often required to re-invest a significant portion of their sale proceeds (20–50%, or higher for key persons), subject to negotiations and individual exceptions.

Any gains realised by management on re-investments are, in principle, subject to capital gains tax. If, however, management holds the initial investment through separate holding companies and re-invests through that holding company, tax would be avoided (or more precisely postponed until distributions are made from the holding entity).

It is important both for management and for the private equity fund that management's investment is made at fair market value, although the tax authorities have historically recognised that the shares acquired by management can be transferred at a reduced market value (typically a 20-30% reduction) to reflect the value impact of lock-up provisions, minority position and illiquidity. These reductions are typically calculated based on the Black-Scholes-Merton approach. If the incentives for the management are not granted at market price, any benefit achieved by management on the (re)investment would typically give rise to payroll tax as opposed to tax on capital gains (payroll tax is higher) for the management in question and also trigger social security contributions for the employer entity of up to 19.1%.

At fund level, incentivisation of key personnel is commonly equity-based. The AIF Act imposes certain remuneration restrictions on AIFMs.

8.2 Management Participation

The private equity fund and any co-investor's investment (institutional strip) are typically comprised of a mix of ordinary and preference shares, with a significantly higher percentage of preference shares. Management's strip often primarily consists of ordinary shares, although variation exists, such as requiring management to invest in both the institutional and management strip, with variations depending on the person's role/significance. Institutional strips may comprise shareholder loans, but these are less common due to tax implications.

Preference shares normally entitle the private equity fund to receive its entire invested amount plus a predefined (preferred) return before ordinary shareholders receive distributions; once preferred return (including interest and investment amount) has been distributed, residual proceeds are allocated to ordinary shares.

Management is usually more heavily exposed to ordinary shares and may potentially earn a higher relative return on their investment in successful exits (reflecting the increased risk associated with the ordinary shares), but faces limited distributions if proceeds are insufficient.

Incentive schemes for management have evolved from option and bonus-based to predominantly investment-based models, although exit bonus arrangements (subject to payroll tax and social security contributions) are also applied.

Management typically invests via the Norwegian holding structure (TopCo or, if a MidCo level is in place, MidCo). For management, particularly for minority positions, it is common to establish a separate management holding company (ManCo) co-owned and (indirectly) controlled by the private equity fund.

8.3 Vesting/Leaver Provisions

Management co-investors are usually required to accept call options for their shares in the event that their employment in the target group is terminated. Leaver provisions are typically divided into:

- good leavers (eg, long-term illness, retirement, disability, death or involuntary termination without cause);
- bad leavers (eg, voluntary termination prior to exit, summary dismissal or material breach); and
- occasionally, "intermediate" or "very bad" leavers.

Generally, a good leaver receives fair market value for the shares, whereas a bad or very bad leaver must sell at a discount, typically the lower of cost and between 50% and 100% of fair market value.

Leaver provisions in Norwegian private equity deals are not always linked to a vesting model, but this is fairly common. The provisions are typically time-based, linked to the good leaver and/or intermediate leaver provisions and vary depending on how early the person in question terminates the employment. A vesting period of up to five years is common, with the underlying principle being that only the vested part of the shares from time to time may ordinarily be redeemed at fair market value, while unvested shares may only be redeemed at a lower value.

8.4 Restrictions on Manager Shareholders

Management shareholders are often required to accept non-compete and non-solicitation provisions in addition to drag, lock-up and standstill, right of first refusal and leaver provisions (including price reductions triggered by leaver events). Non-compete and non-solicitation undertakings typically span 12–24 months, with 12 months becoming more common.

These restrictions are usually (together with other restrictive covenants) included in the share purchase agreement (or other transaction agreement), in the shareholders' agreement, as well as in the employment/service agreement.

Certain regulatory limits on enforceability apply. Under Norwegian anti-trust regulations, restrictive covenants are generally acceptable if they last no longer than three years – depending on the transaction involving important goodwill or know-how – and are geographically limited to areas where the target previously operated.

Furthermore, the Norwegian Working Environment Act stipulates that non-compete clauses imposed by employers must compensate employees and cannot extend beyond 12 months post-employment, except for agreements entered into with CEOs. There is scope to treat restrictive covenants in the employment agreement separate from those applicable to the employee in its capacity as a shareholder and/or selling shareholder.

8.5 Minority Protection for Manager Shareholders

It is uncommon for management shareholders to be granted minority protection rights beyond what is provided under the Norwegian company legislation, unless they possess a significant minority interest and negotiation power. Under Norwegian company law, minority shareholders enjoy certain rights – either by holding one share, or by representing a certain percentage of the share capital and/or voting rights – including the right to challenge corporate resolutions in court, attending and speaking at shareholder meetings, as well as certain disclosure rights. While some of these rights can be waived in the shareholders' agreement, others are statutory and cannot be waived.

Minority rights are often limited through mechanisms like different share classes with varied voting and financial rights, and by incorporating leaver provisions in the shareholders' agreement. Pooling management investments into a separate ManCo (indirectly) controlled by the private equity fund also mitigates the influence of minority protections.

Management is rarely granted anti-dilution protection, veto rights or control over exits. Management may be granted the right to board representation or an observer seat, but in practice this does not give management shareholders any influence or control over the portfolio company.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

Norwegian private equity funds typically seek control over portfolio companies to exercise active ownership, achieved through majority shareholding and typically governed by a shareholders' agreement (which is also an alternative if a controlling interest is not obtained). The funds typically secure right to information, board control and all key decisions, including share

issues, major acquisitions, business changes or asset disposals, borrowing, business plans and budget, and procedures for liquidation and exit. While the shareholders' agreement may also include veto rights for the private equity fund, these are at the outset redundant where the fund possesses a controlling interest.

9.2 Shareholder Liability

Pursuant to Norwegian law, a company and its shareholder(s) are separate legal entities, generally not liable for each other's obligations. This applies regardless of the company's structure, including subsidiary-parent arrangements. In general, the limitations on shareholders' liability under Norwegian law are robust.

Case law predominantly supports maintaining the corporate veil, even where the company is engaged in high-risk business, reserving its piercing only for exceptional cases. There is no Supreme Court precedent for piercing the corporate veil. There is, however, a risk that a shareholder (and especially a parent company) may incur liability for a subsidiary's environmental obligations under Norwegian environmental legislation.

10. Exits

10.1 Types of Exit

The typical target holding period for Norwegian private equity investments ranges from three to five years, as funds aim to return capital with appreciation to investors within a reasonable timeframe.

Trade sales and IPOs have historically been considered the preferred exit strategies. Before 2020, trade sales to industrial investors or secondary sales to other private equity funds dominated in the Nordic countries, to a large extent replacing IPOs. The surge in IPOs during 2020-2021 declined significantly by 2022 and 2023. Comparative data for the first halves of 2024 and 2023 shows a stable IPO trend, as detailed in **1. Transaction Activity**. The 2024 IPO activity remains much lower than the 2020-2021 peak, suggesting that the high activity was a driven by specific market conditions, rather than a shift in trends.

Typically, exits involve either a "dual track" process – ie, combining an IPO and sale process – or more commonly, a trade sale alone.

"Triple track" exit processes have traditionally been less common and if a recapitalisation (or refinancing) is not conducted independently from an exit, it is typically explored once it is determined that there is limited interest in the market.

Private equity sellers occasionally reinvest upon exit, particularly if the funds' initial ownership period was short or if a future significant upside is anticipated.

We continue to see the increasing trend of investments being rolled over into continuation vehicles or later flagship funds in general partner-led transactions.

10.2 Drag and Tag Rights

Drag and tag rights are typical in equity arrangements in Norwegian private equity deals to facilitate exits.

Institutional co-investors and management must usually accept drag mechanisms in the shareholders' agreement for the relevant investment. The typical drag threshold ranges between 50% and two-thirds of the aggregate equity. In subse-

quent exits or sales, target shares are typically sold voluntarily, making the actual use of drag rights rare.

Institutional co-investors and management are generally granted tag rights if the private equity fund sells its stake in the portfolio company. These tag rights, like drag mechanisms, are included in the relevant shareholders' agreement and typically have a threshold of 50% or more of the aggregate equity.

10.3 IPO

In an IPO exit, the private equity seller typically faces a lock-up period of six to 12 months.

It is uncommon for the private equity seller and target to enter into relationship agreements.

PORTUGAL

Law and Practice

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Morais Leitão, Galvão Teles, Soares da Silva & Associados is a full-service law firm in Portugal, with decades of experience in its area of expertise. In addition to transactional work, the firm's private equity (PE) team specialises in fund formation and regulatory matters. Its PE team consists of two divisions: transactional work in which a private equity or venture capital player is involved, and fund formation and regulatory work for private equity or venture capital vehicles. Aside from advising some of the most sophisticated funds operating in Portugal, the firm also assists new clients in establishing a presence in the PE sector each year. Its lawyers have experience in energy and clean tech, infrastructure, banking and insurance, retail and consumer goods, and telecommunications.

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Diana Ribeiro Duarte co-heads Morais Leitão's private equity team and is an integral member of the firm's corporate practice areas, being also one of the team members providing Sustainability: ESG and Human Rights-related services in connection with the PE sector. She has extensive experience in the legal challenges presented by setting up and operating private equity vehicles, including the numerous regulatory procedures that they are subject to under EU and Portuguese law. Her legal practice is increasingly focused on advising private equity investors on mergers and acquisitions transactions, including share deals, leveraged investments, joint ventures, structuring and executing the investment rounds, and exits.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

In the first half of 2024, the Portuguese M&A market tallied 252 completed transactions, amounting to EUR4.6 billion, according to the latest TTR Data ranking (during the period ranging from 1 January to 30 June 2024). This represents a 24% reduction from the number of transactions recorded and a 16% reduction on capital deployed in the same period last year.

Regarding private equity transactions in Portugal, 24 transactions were recorded in the first half of the year, totalling EUR587 million (no data has been provided regarding changes vis-à-vis the same period of 2023).

The Amadeus (travel technology giant) acquisition of Vision-Box (provider of cutting-edge technology for biometrics identification platforms in travel ports), backed by a private equity fund managed by Keensight, was highlighted as the most notable deal of 2024 in Portugal to date involving private equity – the deal value amounted to approximately EUR320 million.

1.2 Market Activity and Impact of Macro-Economic Factors

From a macroeconomic perspective, Portugal is behaving like other advanced economies – the rise and now stabilisation in interest rates to curb inflationary pressures have continued to adversely impact M&A and private equity deal activity, while geopolitical tensions have also played a role in increasing the risk on financial stability and therefore deal appetite.

From a domestic perspective, the end of real estate-related investments as eligible towards benefiting from the Portuguese Golden Visa regime has prompted the launch of new private equity funds, focusing on a myriad of sectors from technology to R&D, in an attempt to reroute envisaged Golden Visa applicants towards new eligible activities.

Besides the Golden Visa scheme, growth of the Portuguese private equity market was supported by several other public programmes such as *Programa Consolidar* (attribution of EU COVID-19 recovery funds to support ailing but financially viable businesses), *Programa Venture Capital* (attribution of EU COVID-19 recovery funds to

invest in start-ups in priority sectors such as software, energy, climate and life sciences) and SIFIDE (tax break scheme given to investors of, inter alia, private equity funds which invest in R&D-focused companies), all having a positive impact and aiding in the increase of the competitiveness and attractiveness of the industry.

Lastly, Portugal's lively start-up ecosystem has also been attracting the attention of private equity and venture capital investors (Portuguese and foreign alike), with an increased interest in early-stage investment.

At the fundraising level, domestic fundamentals remain strong with the same trends from previous years influencing activity.

- Public funds to revitalise Portuguese SMEs and invest in Portuguese start-ups, some of which are mentioned above, are still available mostly through the Recovery and Resilience Plan (focusing mainly on supporting the green and digital transition).
- National and geopolitical tensions as well as the spotlight cast on Portugal as an investment and living destination continue to attract significant investment from high-income individuals in order to obtain a Golden Visa by investing in funds.

These fundamentals have caused considerable and steady growth in the Portuguese private equity industry over the last few years, with assets under management by domestic private equity companies and funds more than doubling from 2015 to 2023 (as assets under management grew from circa EUR4 billion to circa EUR9 billion).

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

In line with the trend in the rest of the EU, the demands regarding regulatory compliance for (alternative) fund managers have been steadily increasing in the past few years. Private equity is not impervious to this.

Adapting to ESG Rules

Private equity fund managers are starting to adapt to European rules on ESG matters, via the mandatory disclosure requirements of Regulation (EU) 2019/2088 of the European Parliament and of the Council (SFDR) as well as Regulation (EU) 2020/852 of the European Parliament and of the Council (Taxonomy Regulation), and respective Level 2 Regulations.

To the knowledge of the authors, there are several private equity funds applying for, operating as and sometimes downgrading to "SFDR Article 8" funds, which reflects a growing interest from investors in the product and efforts from fund managers to structure and implement it (with the hope of improving their chances of successfully fundraising with ESG-driven LPs).

Moreover, the Corporate Sustainability Due Diligence Directive was approved in May 2024, aimed at obliging large EU companies and significant non-EU companies operating within the EU to conduct due diligence across their global supply chains, relating to actual and potential human rights, and environmental adverse impacts.

The Corporate Sustainability Reporting Directive, focused on requiring large and/or listed companies to disclose information on how they manage social and environmental challenges,

has also surpassed all the hurdles derived from the EU legislative process and is now in force.

Both of these regimes may have an impact on private equity, to the extent they have large corporates in their portfolios exceeding the relevant thresholds.

All of these changes show that the legislative evolution on corporate sustainability and sustainable finance matters has been relentless and it continues to be challenging for managers, investors, and regulators to be able to catch up.

New Fund Management Legal Framework

In April 2023, Decree-Law No 27/2003 of 28 April was published, having entered into force in 2023. This statute approved the New Asset Management Framework which performed a full revision of the former private equity legal regime (Law No 18/2015), as well as of the former Portuguese legal regime for UCITS and other alternative investment funds (Law No 16/2015), merging these two statutes into one and enacting noteworthy changes to private equity companies and private equity funds' activities.

With this revision, the Portuguese legislature aimed to create a unified legal framework for the asset management (including private equity) industry, envisaging a simpler, more coherent, and more credible regime by emphasising a risk-based approach and on ex-post supervision (as an alternative to burdensome and lengthy authorisation processes) and very importantly, eliminating excessive regulation over pre-existing Directive provisions (ie, "gold-plating").

Most importantly, the timeframe to incorporate new private equity funds has shortened significantly (given that the registration of most funds is now subject only to a prior notice procedure).

On the other hand, this comes at the expense of legal certainty, as the Portuguese Securities Market Commission (CMVM) currently does not vet the documents being submitted beforehand (ie, because the focus is now on ex-post, rather than ex-ante, supervision); also, with these new rules being approved, many small fund managers are now subject to more organisational requirements and regulation.

In conclusion, the simplification of the regime, making it easier for private equity companies to commence their activities, combined with the elimination of the minimum amount to invest in private equity funds (also an innovation of the new regime), might prove helpful in galvanising the Portuguese private equity market.

So far, since the law has been approved, the number of private equity companies and funds has continued to increase, but seemingly not at an accelerated pace, and it remains to be seen whether this is due to the enactment of the law or if there are other variables at play.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

The main body which provides regulatory oversight for private equity funds (incorporated in Portugal) is the CMVM. In addition to assessing the legality of the registration and incorporation of private equity funds, it monitors their governance, activities, and financial standing.

The main regulators of merger and acquisition activity and foreign investment are as follows:

- the Portuguese Competition Authority and the European Commission for merger control

(which also have jurisdiction when the seller or purchaser is backed by private equity);
- CMVM for offers to acquire listed companies and for public-to-private (P2P) transactions;
- the Portuguese government with regard to foreign investment control and concessions for the operation of certain public goods; and
- sectoral regulators such as ANACOM (telecommunications), ERSE and DGEG (energy), the Bank of Portugal (credit institutions), ASF (insurers and pension funds) and CMVM itself (fund managers and financial intermediaries) also review and clear acquisitions of businesses in the above-mentioned sectors.

For foreign investment control, review is triggered if the potential purchaser is ultimately owned by an entity outside of the European Economic Area or if the target assets are deemed as "strategic assets" for the country (meaning the main infrastructure and assets assigned to national security or defence or to the rendering of essential services in the areas of energy, transportation and communications).

As for foreign subsidies, and under Regulation (EU) 2022/2560 (the Foreign Subsidies Regulation (FSR), the European Commission was endowed with extensive investigative and sanctioning powers. Thus, the notification and compliance obligations for EU companies envisaging M&A transactions and entering into public procurement procedures that are triggered by the FSR (ie, if there is deemed to be a foreign subsidy, meaning if a "third country provides, directly or indirectly, a financial contribution which confers a benefit on an undertaking engaging in an economic activity in the internal market and which is limited, in law or in fact, to one or more undertakings or industries") are being closely monitored by legal advisers when considering potential M&A transactions or the participation in a public procurement procedure. For M&A, the thresholds for the application of the FSR are (i) one of the businesses involved having turnover in the European Union of at least EUR500 million and (ii) subsidies from third countries of more than EUR50 million have been granted by the acquiring company or one of the merging companies in the last three years.

With regards to antitrust, private equity-backed companies are subject to merger control rules, essentially in the same manner as corporates. Turnover and other relevant metrics are normally assessed at the level of the management entity (ie, taking into account the aggregate of the funds managed by the management entity).

If the buyer or co-investor is a sovereign wealth fund, from experience, the authors do not find this leads to enhanced FDI scrutiny relative to other third-country buyers; however, the authors also note that there are sometimes practical difficulties for these entities to go through KYC and onboarding procedures with banks and co-investors.

In relation to sanctions, from anecdotal evidence, there is awareness that the conflict in Ukraine with the ensuing and recently renewed sanctions against some individuals and companies of the Russian Federation make it increasingly difficult for Russian citizens and companies (including those not subject to sanctions) to open and operate bank accounts and use the financial system (in Portugal, as in the rest of the EU). The impact of sanctions on private equity fundraising and deal-making in Portugal, however, appears to have been minimal.

As outlined above (detailed in **2.1 Impact of Legal Developments on Funds and Transactions**), rules concerning anti-bribery and ESG

compliance have been approved and are being implemented by supervisory entities throughout Europe. In this respect (as a sign of the importance of these issues in the economy of regulatory policy), it is worth emphasising that CMVM has published a guide on sustainability for supervised entities with the aim of facilitating and encouraging the adoption of policies and procedures in line with both supervisory expectations and the recommendations of the CMVM and ESMA regarding compliance with the set of standards on sustainable finance.

4. Due Diligence

4.1 General Information

The practice of legal due diligence is common in private equity-driven transactions in Portugal, especially when private equity sponsors are involved.

The due diligence process is usually conducted on a "by-exception" or "red flag" basis (except there are key contracts or other legal instruments underlying the target business, in which case, the respective main legal terms are described).

The key areas include material agreements, licences and regulatory environment, corporate and intragroup relationships (services agreements, cash pooling, etc), and financing. Taxes are also a common concern (but are often dealt with separately from legal due diligence).

4.2 Vendor Due Diligence

A vendor due diligence is often conducted in transactions involving private equity sellers in order to (pre-emptively) resolve or flag any legal issues the target may be experiencing prior to a sale and/or to get buyers up to speed on the company and to impose "fair disclosure" exceptions on the purchase and sale agreements (pertaining to the report's conclusion).

Advisers involved in preparing the vendor's due diligence reports are often asked to provide a statement of reliance to the financing banks of the buyer. It is common for the buyers' advisers to provide such reliance in their own reports (to banks and to insurance companies, in the latter case, if warranty and indemnity (W&I) insurance is obtained for the transaction).

A general disclosure of information to buy-side advisers is common, but it is not accompanied by reliance (except for financing banks as previously mentioned and W&I insurance providers).

In an auction sale, the seller will also typically provide bidders with presentation decks (often accompanying management presentations) which contain highlights on the activities of the business or assets being sold, as well as non-public information on certain financial, operational and commercial metrics. Transaction structure and key legal matters are sometimes also addressed.

5. Structure of Transactions

5.1 Structure of the Acquisition

Most acquisitions by private equity funds are made through private sale and purchase agreements of equity participations in the target company. Asset sales occur less often due to tax and legal structuring reasons.

When companies wish to divest an unincorporated part of their business, they typically restructure the same in advance through a carve-out process.

Court-approved schemes in insolvency or reorganisation proceedings have also gained popularity in distressed transactions, notably debt-equity swaps in real estate assets and related businesses (hospitality and logistics).

In terms of process, auction sales are becoming more common, notably in larger deals; by encouraging competition between potential bidders, auction sales typically make the transaction more seller-friendly (by improving the price, as well as offering more favourable terms in warranties and indemnities).

5.2 Structure of the Buyer

A typical private equity investment structure in Portugal involves a private equity fund managed by a regulated management entity that incorporates a wholly owned special-purpose vehicle (SPV) to complete the acquisition (usually for liability ring-fencing purposes).

The SPV is then funded with equity from the fund (capital, quasi-equity contributions or shareholder loans) to complete the acquisition, and in larger deals bank financing is also obtained.

5.3 Funding Structure of Private Equity Transactions

The typical funding structure has not seen significant developments or changes in the past few months, with private equity transactions being usually financed through equity or quasi-equity, from the private equity fund, and debt (depending on the transaction size, the financing structure and the type of assets involved).

To increase certainty from the seller's side to receive the price, equity commitment letters are often requested from the private equity buyer's structure, either from a corporate entity higher up in the fund's chain of control or from the fund itself, especially in auction sales.

As far as ownership is concerned, the level of equity participation of the private equity fund depends on the type and circumstances of the transaction: for example, in management buy-outs and "growth" transactions, funds typically hold a minority share of the equity, whereas in distressed transactions, a fund retains the majority or all equity in the entity.

In some larger transactions, private equity purchasers sometimes present commitment letters issued by lenders with non-binding offers or binding offers, either because the certainty of funds is required by sellers in the auction or because they wish to strengthen their bid.

Usually, the debt-funded portion of the purchase price will not be fully binding at the signing stage of the transaction. Often, the full debt financing package remains subject to finalisation after the signing, and the debt commitment is contingent on certain conditions, such as the lenders' due diligence and fulfilment of specific financial and legal requirements.

Overall with higher interest rates, the authors find that financing M&A deals in general (and also private equity) has become more difficult.

5.4 Multiple Investors

Consortium Deals

Portugal does not commonly engage in deals involving consortium sponsors; however, when the target size is such that private equity sponsors are required, such a consortium may be formed. Such is the case in the purchase of an 81% stake in Brisa, Portugal's largest highway toll operator, by a consortium of three private equity pension fund investors as well as six

hydroelectric plants in the North of Portugal from EDP, Portugal's largest industry and utility company.

Similarly, consortia comprising a private equity fund and a corporate investor are not very common in the realm of private equity deals in Portugal.

Co-investment Business Models

There are some fund managers (eg, institutional asset managers and "first tier" foreign private equity firms) who are exploring joint-investment arrangements in large transactions with unit holders (the equivalent of the limited partner in the Portuguese context).

In these cases, the fund will own a minority (largely passive) interest in the acquisition vehicle that is majority-owned by one or more of its unit holders.

Club Deals

There appears to be a heightened interest in the private equity market for club deals, both among traditional players and newcomers. Nonetheless, investors should be aware of the regulatory implications of taking this route, as the definition of alternative investment funds under European law (and the regulations resulting from that definition) may be broad enough to encompass certain co-investment structures as well.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Price adjustment mechanisms in M&A transactions (involving both private equity and corporates) usually have either locked-box or completion account mechanisms. Fixed price transactions (ie, with no adjustment whatsoever) are not common.

Locked-box mechanisms are being increasingly utilised due to their ease of use over the "completion accounts" mechanism (which entails the preparation of target accounts as of the date of closing, a process that is usually costly and time-consuming).

To protect the interests of buyers, private equity sellers agree not to, for instance:

- engage in transactions that would cause value to "leak" from the target group (in locked-box structures);
- allow the buyer to dispute draft completion accounts; and/or
- cause material changes to the company during the period between signing and closing (in both cases).

This does not differ materially from deals where sellers are corporates.

Private Equity Buyers and Volatile Turnovers

Private equity buyers provide equity support/commitment letters as a way to provide surety to the seller that the price will be paid (as well as other eventual pecuniary obligations fulfilled). A parent company guarantee (which would in theory offer stronger protection than equity support instruments) or the private equity fund as a joint and several obligor are situations that are not frequently encountered.

In transactions involving businesses with volatile turnover and in which management remains within the organisation (such as a management buyout) earn-outs are often agreed upon by the parties to the transaction.

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6.2 Locked-Box Consideration Structures

In locked-box structures, interest is usually charged on amounts classified as leakage, although this is not always the case.

On the other hand, the practice of charging "reverse" interest on leakage during the locked-box period varies across deals and is not a standard feature. However, it is not unheard of; sometimes negotiation between the parties for the specific terms outlined in the locked-box provisions lands in such a result (notably if there is negotiation leverage from the buy side).

6.3 Dispute Resolution for Consideration Structures

Independent experts (indicated by a joint selection process of buyer and seller, and usually an international audit/consultancy firm or investment bank) are typically used to determine leakage values in locked-box models and cash/debt/change in working capital values in completion account models. It is far less common resolve such disputes through arbitration or judicial court proceedings.

The types of experts and mechanics of the dispute resolution mechanism usually depend more on the particularities of the transaction than the type of price structure used.

6.4 Conditionality in Acquisition Documentation

Albeit common when it comes to conditions of a regulatory nature, conditionality in acquisition documentation is not prevalent, notably in an auction sale, because it reduces certainty for the seller that it will be able to complete the deal.

In particular, prior to the COVID-19 pandemic, conditions other than those of a regulatory nature were not common, although sometimes third-party consents in key contracts (notably pre-existing financing arrangements or concession agreements) and prior corporate restructurings are included. Making the transaction conditional on obtaining financing is rare (and usually "prohibited" in auction sales' process letters).

The pandemic resulted in an increase in:

- the use of material adverse change/effect clauses; and
- the use of conditional and deferred price structures (making the calculation of the purchase price more complex).

6.5 "Hell or High Water" Undertakings

To increase certainty in execution, sellers usually include such undertakings in transaction documents, particularly in auction sales, again to increase certainty in execution; however, these undertakings are usually successfully resisted by buyers, particularly private equity buyers who have demanding financial return objectives (which could be adversely affected if portfolio companies are divested too soon) and are often constrained by their investment mandates.

Although the authors have seen increasing FDI controls in cross-border transactions (including in the EU and US), and even with the new EU FSR regime, there has not been a material difference in Portugal in this regard (ie, the level of deal variation the purchaser is required to withstand as a result of the outcome of these clearance procedures is often included with no distinction for both merger control, FDI and FSR control).

6.6 Break Fees

In Portugal, break fees and reverse break fees are rarely applied.

6.7 Termination Rights in Acquisition Documentation

Termination rights are usually assigned to a private equity seller (ie, if the closing of the agreement does not occur by the long-stop date).

Private equity buyers are typically allowed to terminate their investments in the following circumstances:

- closing of the agreement does not occur by the longstop date;
- failure by the seller to comply with material closing actions; and/or
- (in buyer-friendly transactions) the occurrence of a "material adverse change".

The longstop date, typically agreed upon during the negotiation phase, can vary widely (anywhere from three months to a year, or even more) based on the deal's complexity, the number and type of conditions precedent it is subject to, industry, and other considerations.

6.8 Allocation of Risk

In transactions where the seller is a private equity fund, the risk allocation is typically shifted in its favour (compared to a "corporate" seller). The primary reason is that the private equity seller has a limited period in which it may be liable (private equity funds are eventually dissolved and wound up). Long lists of warranties, extended warranty claims periods, and indemnities are thus rendered less effective (and less acceptable to the private equity seller).

In cases where the buyer is a private equity fund, there are no fundamental differences in risk allocation in relation to a "corporate" buyer: those are determined primarily by the economics and circumstances of the transaction. The main limitations of liability for private equity sellers are those related to breach of representations and warranties in acquisition agreements (detailed in **6.9 Warranty and Indemnity Protection**), however, these limitations (quantitative and with regard to time) on liability may also apply to a breach of other undertakings or covenants under the agreement by the seller.

6.9 Warranty and Indemnity Protection

The warranties provided by a private equity seller to a buyer on an exit are usually limited. In most cases, "Fundamental warranties" are provided regarding the existence (of the seller and the target), capacity to enter into the agreement, and share ownership. "Business" warranties are more limited and reserved for certain key matters. Private equity sellers' liabilities arising from breach of warranties are usually subject to caps in liability for breach of warranties, de minimis and basket provisions.

The contents of the data room and disclosure letters typically exempt the seller from liability in the case of breach of warranties. Moreover, it has an advantage for the buyer as it precipitates the disclosure of many issues which might otherwise be kept "under the radar".

Typical quantitative limitations on liability include:

- cap for breach of warranties – 10% to 20% of the aggregate consideration;
- time limitations to claim for breach of warranties – 12 to 24 months;
- de minimis – 0.1% of aggregate consideration; and
- basket – 1% of aggregate consideration.

In turn, qualitative limitations in the acquisition agreement usually include:

- issues known and fairly disclosed;

- changes in the law;
- liabilities provisioned in accounts; and
- actions which have been agreed in writing with the purchaser.

If the event that W&I insurance is contracted, however, these limitations will necessarily be different (ie, the buyer acknowledges that it will not make a claim under the acquisition agreement and that claims regarding breach of warranties will be brought against the insurance company under the terms of the insurance policy which, in turn, also includes its own limitations).

6.10 Other Protections in Acquisition Documentation

Besides warranties, other protections offered by a private equity seller in an acquisition agreement include interim period obligations (including limitation on the management of the target company outside of the ordinary course of business) as well as pre- or post-closing undertakings (idiosyncratic to the transaction). There are also mechanisms for price retention, but indemnities are rarely provided.

With relation to W&I insurance, the same is an increasingly common feature in Portuguese PE transactions. Policy costs (which are relatively expensive) are usually borne by the buyer and cover a wide range of business warranties based on due diligence conducted by the insurance company (which, in turn, takes into account the vendor's due diligence and the buyers' due diligence).

Fundamental warranties and "plain vanilla" tax warranties are increasingly being covered by W&I insurance as well. On the other hand, pollution liability, pension underfunding, certain tax liabilities and sanctions are some of the common exclusions.

6.11 Commonly Litigated Provisions

A private equity transaction rarely ends in litigation (especially when arbitration is used as a dispute resolution method, where its costs act as a relevant deterrent). The majority of pre-litigation disputes concern (alleged) breaches of warranty and the applicability of earn-out provisions (eg, whether the respective earn-out events have been triggered).

7. Takeovers

7.1 Public-to-Private

In Portugal, P2P transactions are uncommon. The only P2P transaction to have succeeded is the takeover of Brisa, the above-mentioned highway toll operator (see **5.4 Multiple Investors**) by its reference shareholder and a private equity sponsor (Arcus).

In the context of a public-to-private transaction, the target company and its board play a critical role, since the latter has a fiduciary duty to act in the best interests of the company and its shareholders. When evaluating a public-to-private offer, the board must thoroughly assess the offer's fairness and explore alternative options.

In addition, under the provisions of the Portuguese Securities Code, the board is required to produce a report on the fairness of the consideration being offered and its views on the impact of the transaction on the company's strategic outlook and employment conditions.

Given issues of equitable treatment of investors and market abuse rules, relationship agreements or transaction agreements between the bidder and the target company are not common.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Under the provision of Article 16 of the Portuguese Securities Code, any person that reaches 5%, 10%, 15%, 20%, 25%, 33%, 50%, 66% and 90% of the voting rights of: (i) a company listed in a Portuguese regulated market (or reduces its level of voting rights below said thresholds) must, as soon as possible, and within a maximum period of four trading days after the occurrence of the fact or knowledge of the same, inform CMVM and the target company.

The communication must:

- identify the market participant as well as the individual or legal person entitled to exercise voting rights on its behalf (when applicable);
- show the entire chain of entities to which the participation is attributed (whether national or foreign);
- explain the situation by which voting rights inherent to securities owned by third parties are attributable to the market participant;
- contain the percentage of voting rights attributable to the holder of the participation, the percentage of the share capital and the number of shares corresponding, as well as, when applicable, the identification of the participation by category of shares (when the issuer has several categories outstanding) and the title of attribution of voting rights; and/or
- show the date on which the participation reached, surpassed or was reduced to the above-mentioned thresholds.

Even simple changes in the chain of attribution of voting rights must also be notified to CMVM and the target listed company.

7.3 Mandatory Offer Thresholds

A person that has over 33% or 50% of the voting rights of a listed company has a duty to launch a public tender offer over the entire share capital and other securities issued by such listed company which grant the right for their subscription or acquisition (Article 187 of the Portuguese Securities Code).

If a person exceeds only 33% of the voting rights of the listed company, the obligation to launch a mandatory tender offer will, however, not arise if the person that is bound by such obligation proves before CMVM that it does not have control of the target company nor is it in a group relationship with the target company.

The consideration offered in a mandatory offer must be the highest of:

- the highest price paid or committed to be paid by the offeror or any person whose voting rights are attributable to it during the six months prior to the announcement of the offer; or
- the volume weighted average price of the stock in the six months prior to the offer.

7.4 Consideration

The consideration in public tender offers can be made in cash or in securities.

Typically, cash is the consideration of choice in tender offers, perhaps due to the relative "shallowness" of the Portuguese equity capital market.

7.5 Conditions in Takeovers

Common conditions to launch the offer, incorporated in the offer announcements, include unblocking of voting limitations in the general shareholders' meeting (when by-laws of the tar-

get include such voting limitations) and regulatory clearances.

The effectiveness of the offer (when the offeror seeks to obtain control of the target company) is usually subject to the condition of obtaining more than 50% of the voting rights in the offer.

It is not generally allowed under Portuguese law for a takeover offer to be conditional on obtaining financing, given the fact that the buyer must have funds available to pay the full price resulting from the offer.

To ensure the protection of the bidder in the offer, break fees have been referenced as a way for the bidder to cover its costs should the offer not be successful. While not expressly prohibited under Portuguese law, break fees carry a considerable degree of risk for the target company's directors, given that:

- the fee could be considered a breach of directors' duties (if the fee is proven to be a way to entrench management or to favour one shareholder over another); and/or
- if the fee is sufficiently high, this could breach the "passivity rule", which prevents management from making material decisions that would affect the target company before the offer is completed.

The law allows bidders to increase the price offered at any time, especially when a competitive bid is being submitted.

7.6 Acquiring Less Than 100%

Outside their shareholding, a person acquiring less than 100% in a tender offer can make use of the statutory squeeze-out procedure to acquire the entire share capital of the target.

If a purchaser (by itself or through related entities whose voting rights are attributable to it) holds more than 90% of the voting rights in a Portuguese listed company up to the assessment of the offer results, it may in the three subsequent months acquire the remaining shares through fair consideration, in cash.

The consideration offered must be the highest of:

- the highest price paid or committed to be paid by the offeror or any of the persons whose voting rights are attributable to it during the six months prior to the announcement of the offer; or
- the volume weighted average price of the stock in the six months prior to the offer.

There is no statutory threshold for a private equity-backed bidder to achieve a debt push-down into the target following a successful offer.

The offeror that intends to launch a squeeze-out procedure must immediately announce it and send it to CMVM to be registered. At the order of the remaining shareholders, they must also deposit the total consideration in a credit institution.

The acquisition of the remaining shareholders under a squeeze-out procedure is effective from the date of publication, by the offeror, of the registration before CMVM.

7.7 Irrevocable Commitments

The negotiation of irrevocable commitments in tender offers that occur prior to the announcement of the transaction is not common in Portugal.

In order to ensure that these commitments, which must in principle be disclosed, do not result in the CMVM evaluating the voting rights of the committing shareholders as being attributed to the offeror (which may trigger mandatory public offer thresholds), protections are sometimes provided for investors who wish to accept competing offers or exit in another manner.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Offering managers equity incentives/ownership is a common, but not inevitable, feature of private equity transactions in Portugal.

There is no standard way to attribute management shares, with equity participations ranging anywhere from residual (5–10%) to significant (40–49%). In certain management buyout transactions, management will hold the majority of the share capital post-transaction.

Employee stock option plans (virtual or physical) are sometimes also used for management and other key company employees.

8.2 Management Participation

Managers are often granted common shares with vesting provisions, and preferred instruments are not commonly used in management equity. In addition, sweet equity (equity issued at par or at a discount to managers) is not commonly linked with standard business practices or legal structures in Portugal.

8.3 Vesting/Leaver Provisions

Vesting provisions for management equity have become increasingly popular in Portugal, especially among start-ups and high-growth companies backed by venture capital or private equity investors. The primary aim of introducing these provisions is to incentivise and align the interests of management with the company's long-term prosperity. Generally, these provisions outline that the rights associated with the equity shares granted to management will gradually become effective over a specified timeframe, subject to continuous employment or the achievement of predetermined performance objectives.

Good leaver/bad leaver provisions, which qualify the circumstances in which managers cease holding participation or directorships/employment positions in the target, are normally included in shareholders' agreements regarding the target, which are entered into between management and the private equity sponsor.

Good leaver provisions are triggered if managers are forced to depart from the company due to extreme circumstances outside of their control (such as a serious disease or injury). In turn, bad leaver provisions are usually triggered if managers leave the company without being considered good leavers.

In venture capital transactions, vesting provisions (where management is prevented through contractual means from fully owning the equity participations acquired/subscribed in the transaction) are also included in the relevant shareholders' agreement. The vesting period will be three to four years long, with a one-year cliff (ie, whereby some share vests) and two to three years of "linear" vesting (for the remaining shares).

If the manager is deemed a bad leaver, private equity sponsors will be granted the right to purchase the former's shares at nominal value. If, however, the manager parts ways with the company as a good leaver (and the agreement is

negotiated in a balanced manner), private equity sponsors will usually be required (or have the right) to purchase the manager's shares at fair value.

8.4 Restrictions on Manager Shareholders

Management shareholders frequently commit to non-compete and non-solicitation undertakings. From an employment law standpoint, they raise concerns by restricting fundamental rights to work and the pursuit of professional livelihood and from a competition law standpoint, by stifling competition; therefore, they may be subject to limitations. With the recent United States Federal Trade Commission ban against non-compete agreements in employment relationships, further developments might also arise at the level of the European Union.

A non-compete clause is subject to the following statutory restrictions:

- they must be entered into in writing;
- they have a time limitation of two years (extendable to three years in certain cases); and
- they must allow consideration to be given to the employee/director in exchange for accepting this clause.

Non-disparagement clauses, where managers agree not to publicly make negative statements regarding the company, are unusual.

Restrictive covenants have the flexibility to be included in multiple documents, encompassing both the equity package and the employment contract. They can be integrated into the shareholders' agreement or other equity-related documentation, specifying the roles and responsibilities of management shareholders. Furthermore, these covenants can also be seamlessly integrated into the employment or administration contracts of the management team, effectively governing their conduct throughout and after their tenure with the company.

8.5 Minority Protection for Manager Shareholders

Manager shareholders, when holding minority participations, are usually provided with contractual protections (in the transaction documents, notably shareholders' agreements) to ensure the integrity of their investments.

In the first instance, managers will usually be entitled to be appointed to the company's board of directors (with executive functions).

Veto Rights

Sometimes manager shareholders are afforded veto rights in shareholders' decisions (eg, share capital increases, issue of options, etc), to prevent the company from engaging in dilutive transactions for the management.

It is common practice to use veto rights and legal pre-emption rights to prevent dilution of manager shareholders in share capital increases. Managers also hold veto rights (in both shareholders' meetings and board of directors' meetings) to prevent the private equity sponsor from unilaterally taking fundamental decisions regarding the company's governance (eg, amending the by-laws), legal characteristics (eg, transform, merge or demerger the company) and strategy (eg, amending the business plan).

These veto rights are typically structured either around a shareholders' agreement (where the protection is contractual, and therefore enforceable only against the management's counterparties) or through shares carrying special rights

(where the protection is enforceable against the company and, therefore, company resolutions in violation of such "special rights" may be challenged on that basis).

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

Majority Participation

In the case where a private equity fund shareholder holds the majority interest in the target company, typical control mechanisms are provided by statute (particularly, the ability to appoint the members of the target company's corporate bodies on one's own – there is no statutory provision providing proportional representation in management or audit bodies under Portuguese corporate law).

Minority Participation

When the private equity fund shareholder has a minority participation in the target company, board appointment rights in shareholders' agreements (proportional or not) are commonly negotiated. Also commonly requested are veto rights at the shareholder level in critical matters (eg, reorganisations, further financing, capital increase and decrease), information rights (eg, the right to receive monthly information on accounts and KPIs) and exit rights (eg, pre-emption rights, tag-along rights, drag-along rights, etc).

9.2 Shareholder Liability

A Portuguese company (extended to EU companies) that wholly owns another Portuguese company is responsible for compliance of the subsidiary's obligations, both before and after it has been incorporated.

Nonetheless, it is doubtful whether this provision applies to private equity funds as opposed to other companies (since private equity funds are not incorporated and have a "proprietary" legal regime of their own that does not include a similar provision).

Nevertheless, there are (rare) cases where it would be conceivable (applying certain general civil law principles) for the legal personality of the portfolio company or special purpose vehicle incorporated for the acquisition to be disregarded and the "corporate veil pierced". This requires proof of behaviour which is fraudulent or obviously against good faith principles.

10. Exits

10.1 Types of Exit

It is typical for a private equity investment to be held for a period of four to seven years before an exit occurs.

From anecdotal evidence, the most common forms of exit seen in recent years were trade sales and secondary sales to other asset managers. A write-off may also occur from time to time.

There have not yet been any initial public offerings (IPOs) or dual-track processes initiated by private equity sponsors in Portugal.

10.2 Drag and Tag Rights

Drag-along rights are typically included in investment documentation to ensure that management and (often) other co-investors are required to sell if an exit opportunity arises.

In Portugal, the typical drag threshold can vary depending on the specific terms negotiated

between the parties. It is often observed that a drag threshold falls within the range of 50% to 75% of the total outstanding shares. This means that if shareholders holding this percentage or more of the company's shares agree to a sale, they can force the remaining shareholders to participate in the transaction through the drag-along rights.

Conversely, the typical tag threshold is usually set at a lower percentage, commonly around 50% of the total outstanding shares (if there is one at all). If shareholders holding this percentage or more decide to sell their shares, minority shareholders can exercise their tag-along rights to join the sale and sell their shares on the same terms.

It is not common for management and institutional investors to have different tag thresholds.

10.3 IPO

In Portugal, there has never been an IPO promoted by a private equity seller (the closest comparison was the debut of a venture capital-backed company on an alternative trading exchange).

In other IPOs in the Portuguese market (not triggered by a private equity exit), where the sponsor retains a majority participation, a relationship agreement is entered into between this dominant shareholder and the listed company to ensure the two entities conduct business in an arm's length manner.

Trends and Developments

Contributed by:
Duarte Schmidt Lino, Tomás Almeida Ribeiro and Maria Almeida Pulido
PLMJ

PLMJ is a law firm based in Portugal that combines a full service with bespoke legal craftsmanship. For more than 50 years, the firm has taken an innovative and creative approach to producing tailor-made solutions to defend the interests of its clients effectively. The firm supports its clients in all areas of the law, with multidisciplinary teams and always acting as a business partner in the most strategic decision-making processes. With the aim of being close to its clients, the firm created PLMJ Colab, its collaborative network of law firms spread across Portugal and other countries with which it has cultural and strategic ties. PLMJ Colab makes the best use of resources and provides a concerted response to the international challenges of its clients, wherever they are. International collaboration is ensured through firms specialising in the legal systems and local cultures of Angola, Cabo Verde, China/Macao, Guinea-Bissau, Mozambique, São Tome and Príncipe and Timor-Leste.

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Overview of the Portuguese Economy

Over the past two years, the Portuguese economy has faced a series of international shocks, such as COVID-19 and the war between Russia and Ukraine, all of which naturally impacted the local economy. Additionally, some structural issues continue to hinder the growth of national GDP, including (i) low productivity, (ii) labour market rigidities, (iii) high levels of bureaucracy and overall administrative inefficiency, (iv) high levels of public debt, (v) excessive reliance on small and medium-sized enterprises (SMEs), which often face challenges in scaling up, accessing finance, and competing internationally, (vi) high tax rates, and (vii) demographic challenges. However, promising signs of recovery are emerging.

According to the Bank of Portugal, these shocks have resulted in slowed external demand, increased inflation, and tighter monetary policies, leading to deteriorating financial conditions. Despite these challenges, economic growth has been supported by robust export activity, reflecting a recovery in demand for certain services post-pandemic, and gains in market share.

The impact of recent shocks is expected to dissipate, according to the Bank of Portugal, with an improved international environment on the horizon. Internal demand is set to benefit from reduced inflation, less restrictive financing conditions, and the implementation of projects funded by European funds, accelerating from 1.4% in 2023 to an average of 2.4% in 2025–26.

Exports will continue their dynamic growth, averaging 3.8%, as external demand picks up and market share increases, partially offsetting the fading post-pandemic service recovery. The labour market is expected to remain strong, with annual employment growth around 0.9% and an unemployment rate near 6.6%, below the trend.

This economic expansion has coincided with a dynamic labour market, with labour supply constraints alleviated by an increase in the active population, driven by higher activity rates and positive migration balances.

With these components, the Portuguese economy is expected to grow between 2% and 2.3% in 2024–26, outperforming the Euro area. Inflation will drop to 2.5% this year, 2.1% in 2025, and 2% in 2026, according to the Bank of Portugal.

The growth pattern, driven by strong exports and investment, aligns with maintaining fundamental macroeconomic balances, particularly regarding the external surplus. These factors enable the Portuguese economy to outpace the Euro area's growth by 0.9 percentage points on average. Public debt, which stood at 99.1% of GDP in 2023, is expected to continue to decline, edging below the Euro area average from 2025 onwards.

The Bank of Portugal predicts GDP growth of 2% in 2024. This figure reflects moderate growth in consumption and greater exposure to rising interest rates due to the excessive weight of floating rate loans. The Portuguese government is more optimistic, estimating growth of more than 2% of GDP for 2024.

Overview of the Portuguese Private Equity Industry

Although still relatively small, the Portuguese private equity industry is growing. In 2023, there were 695 transactions totalling EUR13.9 billion, according to TTR Data. This included 150 venture capital transactions amounting to

EUR560 million, 147 asset acquisitions totalling EUR1.985 billion, and 84 private equity transactions totalling EUR1.469 billion. Of these transactions, 45% disclosed their values, providing a clearer view of market dynamics.

The 84 private equity transactions in 2023, totalling EUR1.4 billion, represented a 27% growth compared to 2022. The volume of transactions increased by 16%, with real estate being the most active sector, with 144 transactions. The first quarter of 2024 continued this positive trend, with real estate investments amounting to EUR273 million. The hotel and retail sectors contributed significantly, accounting for 60% of the total investment volume. The internet, software and IT services sector also showed growth, highlighting the diversification of investment opportunities and increasing digitalisation in the Portuguese market.

Despite the positive outlook, the Portuguese private equity market faces challenges such as political and economic uncertainties, both domestic and global, which can impact investor confidence and market stability. Additionally, the relatively small size of the Portuguese market may limit the scale of investments compared to larger European markets. However, the diversification of investment sectors and increasing sophistication of local firms are likely to mitigate these challenges.

The Portuguese private equity industry is showing robust growth, driven by favourable market conditions, supportive regulatory frameworks, and a diverse range of investment opportunities. The continued influx of both domestic and international capital underscores confidence in Portugal's economic prospects and its potential as a prime location for private equity investments.

As the market evolves, keeping up to date with regulatory changes, market trends, and emerging sectors will be crucial for investors seeking to maximise their returns in this dynamic landscape. Foreign investments have significantly shaped the Portuguese private equity market, with Spain and the United Kingdom being the top investors in 2023, accounting for 83 and 42 transactions, respectively. This influx of foreign capital has brought expertise, best practices, and innovation to Portuguese companies, intensifying competition and pushing local firms to enhance their capabilities and adopt more sophisticated investment strategies.

While foreign investments are largely positive, challenges such as regulatory complexities and political uncertainties remain. Nevertheless, the Portuguese government has been proactive in creating a favourable regulatory environment, with initiatives like the Golden Visa programme and tax incentives for R&D activities enhancing Portugal's appeal as an investment destination.

Overall, the continued influx of foreign investments is expected to support the growth and diversification of the Portuguese private equity market, emphasising the importance of maintaining an international and investor-friendly environment to capitalise on global economic opportunities.

Trends in the Private Equity Ecosystem in Portugal

New legal framework

At the end of 2023 and the beginning of 2024, the legal framework for asset managers, the Asset Management Framework (RGA), and the regulation of the Asset Management Regime (RRGA) issued by the Portuguese Securities Market Commission (CMVM) were approved and entered into force. The RRGA clarifies and

details various changes to the regulatory framework for collective investment undertakings (CIUs) in Portugal, aiming to simplify and clarify regulatory proposals and favour ex-post supervision over ex-ante supervision.

This new legal framework contributes to the codification, simplification, and elimination of some restrictions applicable to CIUs and management companies.

SIFIDE tax regime

In 2024, the legal regime of SIFIDE, a tax incentive scheme for business R&D, underwent key changes to enhance its effectiveness, and these changes have been applicable since 1 January 2024. Investment funds must now hold their units for ten years and invest at least 90% in R&D, with a reduced investment period of three years. New regulations also focus on supporting technological start-ups and scale-ups, aiming to create a more rigorous and sustainable innovation environment.

The SIFIDE legal framework is expected to be amended once again soon, as these measures were discussed and approved by the Council of Ministers on 4 July in the "Accelerate the Economy Programme". These approved measures will be put into law by the government and/or the Portuguese Parliament, depending on the matter in question, by the end of 2024. Proposed amendments include reducing the R&D expenditure requirements for investee companies from 7.5% to 5% of their turnover in the previous year, giving SIFIDE funds two years to invest in R&D companies, and allowing 20% of SIFIDE funds to be invested in productive innovation.

With significant capital to deploy, these SIFIDE funds have substantial capital to deploy in the Portuguese economy, and a number of transactions involving SIFIDE Funds are expected to occur within the next 12 months.

Programa Consolidar

The Consolidate Programme (*Programa Consolidar*), launched by the Portuguese Development Bank, aims to support the capitalisation of SMEs and mid-caps affected by the COVID-19 pandemic. The programme will run until 31 December 2030, with the investment period until 31 December 2025. Initially funded with EUR250 million from the Recovery and Resilience Plan (*Plano de Recuperação e Resiliência* or PRR), the budget was increased to EUR500 million, with a mandatory private sector contribution of at least 30%, bringing the total funds to EUR752 million. Each fund must secure between EUR10 million and EUR50 million from the Capitalisation and Resilience Fund (FdCR), with a minimum fund size of EUR40 million. The programme targets economically viable companies in a wide variety of sectors such as industry, agribusiness, health, commerce, tourism, transport, logistics, and services. Its aim is to enhance their innovation, growth, and competitiveness. Benefits include tax incentives, financial support, lower investment risk, regulatory support, and capacity building.

Until March 2024, the Consolidate Programme had reached 15 companies, investing EUR83.1 million, with an execution rate of 8.5%. From March 2024 onwards, an additional ten companies were reached under the programme, according to data from the Portuguese Development Bank. As investments must be made by the end of 2025, it is expected that investments covered by the programme will be carried out in Portugal during 2024.

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Private equity and venture capital

In 2024, private equity transactions are expected to be predominantly driven by the real estate sector, particularly the hospitality and tourism industries. According to TTR, venture capital transactions increased by 19% in 2023 compared to 2022 in Portugal, with 150 investment rounds totalling EUR560 million. In the Asset Acquisitions segment, 147 transactions were registered with a value of EUR1.9 billion, representing a 7% increase in the number of operations.

The Portuguese Development Bank has developed a specific programme for venture capital to enhance the capitalisation of SMEs and mid-caps with high growth potential. The programme runs until 31 December 2030, with the investment period extending until 31 December 2025. Funded with EUR400 million and a mandatory private sector co-investment requirement of at least 30%, the total funds amount to EUR571 million. Each fund must secure between EUR10 million and EUR30 million from the Capitalisation and Growth Fund (FCC), with a minimum fund size of EUR20 million.

The programme targets economically viable companies in sectors such as technology, industry, health, commerce, tourism, transport, logistics.

PUERTO RICO

Law and Practice

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Ferraiuoli LLC is one of the leading full-service law firms in San Juan, Puerto Rico. It has with an experienced and agile team of professionals who provide unparalleled and personalised service to clients. The firm provides high-quality comprehensive legal advice and representation to industry-leading private and publicly owned companies, as well as financial institutions, on corporate, tax, IP, labour and other regulatory issues. It serves clients in Puerto Rico and the US mainland, as well as the Caribbean and Latin America. The attorneys work in teams, as appropriate, with state-side and international advisers and counsel, and are committed to pursuing clients' business goals in a responsive and cost-effective manner. Several of the firm's attorneys hold dual professional licences and are authorised to practice in the State of New York, the State of Florida, the State of Texas and the State of California, in addition to the Commonwealth of Puerto Rico and the US Federal Courts System.

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Ferraiuoli LLC
Looking Forward

1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

The market for private equity has continued its rapid growth in Puerto Rico, with investors, buyers, and lenders eager to put their capital to work in various sectors and industries. The volume of private equity-related transactions have kept steadily growing and accelerating for many reasons, including a substantial demand among mid-sized and developed businesses looking to expand into new markets; the limited supply of local banks; resilient business and asset valuations; and industry acceptance of the use of private equity funds in various transaction types, phasing out the more traditional financing structures.

There has recently been an increase in private equity firms and venture capital funds carrying out fast-tracked acquisitions and exits, either accelerating long-term strategies to gain market and growth or in response to the fast-paced market. In a fairly short period of time, the evolution of the private equity model in Puerto Rico has created a new engine for M&A transactional work, which includes restructuring of existing and developed businesses. This continuous development of the local private equity framework has proved the deal-making capacity that private equity firms bring to the table.

1.2 Market Activity and Impact of Macro-Economic Factors

The commercial and residential real estate, lending and credit, entertainment, auto, marine, alternative assets (ie, digital and physical collectibles), food and food technology and logistics, tourism and hospitality, technology, renewable energy, hospitality and lodging sectors continued to show significant activity and steady acceleration during 2023 and 2024.

Private equity fundraising has also received a lot of attention from industry leaders, including the banking sector, with both seasoned and new investors showing interest in these types of investment vehicles and open to testing the market. This fundraising momentum is likely to continue into the next year, as well-established players are planning additional capital raises and new private equity firms are opening.

The sustained increase in activity has also drawn the attention of local regulatory agencies, with

the enactment of new regulations and requests for information aimed specifically at private equity firms and ensuring the proper operation of these new investment vehicles.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

The 933 Exclusion

US citizens are generally subject to federal taxation on their worldwide income. The applicable rates vary depending on the nature of the income being generated. US citizens can be subject to rates of up to:

- 20% in the case of long-term capital gains; and
- 37% in the case of ordinary income.

However, US citizens that are also bona fide residents of Puerto Rico are allowed to exclude from federal taxation all their income, be it ordinary income, interest, dividends or capital gains that are derived from sources within Puerto Rico (the "933 Exclusion"). The 933 Exclusion did not historically represent a significant tax saving opportunity for individuals that became PR residents, since PR residents were subject to worldwide taxation in Puerto Rico at rates of:

- 10% to 24% in the case of long-term capital gains; and
- 33% in the case of ordinary income.

However, the Puerto Rico government has enacted various laws to attract individuals and businesses to Puerto Rico, by providing preferential tax rates on specific activities, businesses, and types of income. Private equity funds can currently request a tax exemption grant from the government of Puerto Rico under Act No. 60, known as the Puerto Rico Incentives Code (as amended) (the "Incentives Code").

Incentives Code

The Incentives Code now establishes the general framework for the following:

- requesting treatment as either a Puerto Rico Private Equity Fund (PR-PEF) or Private Equity Funds (PEFs);
- eligibility requirements of both the PR-PEFs and PEFs; and
- the taxation of both the PR-PEFs and PEFs,

among other aspects.

Some of the main attractive characteristics that the Incentives Code provides PEFs and PR-PEFs with, includes allowing investors to take a deduction of up to a maximum of 30% of their initial investment within a maximum period of ten years, provided that the maximum deduction does not exceed 15% of the investor's net income prior to the deduction. Investors that invest in a PR-PEF are eligible to deduct up to a maximum of 60% of their initial investment within a maximum period of 15 years, provided that the maximum deduction does not exceed 30% of their net income prior to the deduction. These deductions can be used against Puerto Rico-sourced income, providing a significant tax efficiency to both PR residents and those investors that are not residents but have Puerto Rico-sourced income.

The general rule is that an investor's share of income derived by a qualifying fund from interest and dividends is subject to a fixed income tax rate of 10%. However, the distributive share of investors that are registered (or exempt) investment advisers, private equity firms or general

partners in interest and dividends derived by a qualifying fund will be subject to income tax at a fixed rate of 5%.

Capital gains

In addition, an investor's distributive share of capital gains realised by the qualifying fund is exempt from Puerto Rico income tax. Generally, income from the sale of personal property, such as the units or shares of a qualifying fund's portfolio companies are "sourced" to the residence of the seller. If the seller is a US tax resident the source of the income is deemed to be the USA. On the other hand, if the seller is a non-US resident (ie, a PR resident), the income is generally foreign-sourced. Therefore, PR residents that invest in a qualifying fund may enjoy a complete exemption on the capital gains realised by the qualifying fund.

The general rule is that capital gains realised by an investor upon the sale of their ownership interest in a qualifying fund will be subject to Puerto Rico income tax at a rate of 5%. However, if the investor is a registered (or exempt) investment adviser of the qualifying fund, a general partner, general member of the qualifying fund or a private equity firm, then the gain will be subject to income tax at a rate of 2.5%.

As an exception, capital gains realised by investors upon the sale of their ownership interest in a qualifying fund will not be subject to the 5% or 2.5% tax (as the case may be) if the gross proceeds from the sale are reinvested in a PR-PEF within 90 days of the sale, in which case the capital gains will not be subject to income tax. In the case of investors that are not PR residents, and US citizens, they would be subject to taxation at the applicable federal level.

Puerto Rico-based funds that export their services

In addition to the benefits offered by the Incentives Code to funds and investors, under a separate section of the Incentives Code, certain investment advisers who are organised in Puerto Rico or establish operations in Puerto Rico that provide advice to funds located outside of Puerto Rico or to other investment advisers located outside of Puerto Rico (ie, export their services) may elect to be taxed as corporations to benefit from the 933 Exclusion, and the Incentives Code, which provides a preferential tax rate of 4% for services rendered from Puerto Rico to persons or entities located outside of Puerto Rico, such as funds, other investment advisers or investors.

Dividends

In addition, the Incentives Code provides a 0% rate on dividends distributed by the entity to its owners that are PR residents from income derived from export activities.

The terms of the exemption provided to the entity under the Incentives Code is covered under a contract between the government of Puerto Rico and the entity that requested the benefits. The initial term of the benefits under the Incentives Code is 15 years, which can be extended for an additional 15 years, at the discretion of the government of Puerto Rico.

Relocation to Puerto Rico

Furthermore, under a separate section of the Incentives Code, an exemption from Puerto Rico-sourced passive income (including interest and dividends that flow through the fund) can be obtained by individuals who relocate to Puerto Rico and become PR residents. This includes capital gains, interest, and dividends. The provisions of the Incentives Code that provide these

benefits tie into the 933 Exemption, the sourcing rules of the US Internal Revenue Code (IRC) and benefits offered under the Incentives Code.

For those individuals that use this section of the Incentives Code, their capital gains, interest, and dividends are subject to 100% exemption from Puerto Rico taxes. Therefore, individuals that combine the use of the PR-PEF and the individual tax incentives herein described, would enjoy the benefits of the deduction but also exemption from any capital gains, interest, and dividends generated by the fund. Investors can greatly benefit from the interplay of these rules.

Services provided by investment advisers with a Tax Grant to funds outside Puerto Rico

Lastly, an individual who owns an investment adviser that has a Tax Grant (as discussed above) and provides services to an alternative investment fund or to another investment adviser located outside of Puerto Rico can receive dividend distributions subject to a 0% tax rate.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Private equity funds, venture capital funds, investment managers and their investment advisers organised under the laws of Puerto Rico and/or doing business in Puerto Rico are subject to the laws of the USA, all applicable rules and regulations promulgated by the SEC, the local regulator in Puerto Rico, the Office of the Commissioner of Financial Institutions of Puerto Rico (OCIF) and in some instances to the North American Securities Administrators Association's (NASAA) Model Rules as imposed by the OCIF.

Private equity-backed buyers usually need to comply with the provisions set out in Act No 77 of 1964, as amended, known as the Puerto Rico Anti-Monopolistic Act (the "Act 77-1964"). Act 77-1964 regulates unlawful mergers and business practices, generally to promote fair competition for the benefit of consumers in an open market economy. Act 77-1964 specifically states that it is unlawful to sell, contract to sell, offer to sell, or participate in any step for the sale with the purpose of destroying competition or eliminating a competitor located in Puerto Rico.

The Puerto Rico Department of Justice Office of Monopolistic Affairs (OMA) is authorised to investigate and initiate legal action to protect free competition practices in accordance with the Puerto Rico Antitrust Act, which was enacted to regulate any unlawful restraints of trade or commerce and exempts the legal regulation of public utilities, insurance companies and any other enterprises or entities subject to special regulation by the governments of Puerto Rico or the USA. Under the Puerto Rico Antitrust Act, similar to the federal antitrust laws, a contract, combination in the form of trust or otherwise, or conspiracy that "unreasonably restrains trade or commerce in Puerto Rico" is illegal. With regard to M&A, the Puerto Rico Antitrust Act states that it will be unlawful if the effect of the acquisition may be to "substantially lessen competition, or to tend to create a monopoly". These antitrust regulations will generally apply to business combinations and private equity-backed buyers.

In addition, if the private equity firm or venture capital fund enjoys a preferential tax treatment under the Incentives Code, it will be subject to the oversight of the Office of Incentives for Businesses in Puerto Rico (OI) and the Puerto Rico Treasury Department. Furthermore, depending on whether or not it relies on an exception from

registration under SEC Rule 203-1(l) or 203-1(m), there are different types of limitations on the type of portfolio company acquisitions that the entity can undertake and/or the amount of leverage it can assume.

National security regulators typically do not actively participate in the inspection of investors, as the oversight and regulatory powers are vested in OCIF. During the due diligence process, OCIF therefore requires sufficient disclosure of the circumstances surrounding investments so that an accurate assessment of the regulatory environment is realised. Additionally, the new EU FSR regime does not play a role in transactions in Puerto Rico and we do not anticipate any changes in the near future.

The OCIF has shown increasing interest in investment vehicles in Puerto Rico. In recent months, it has specifically been focused on private equity fund or venture capital fund registration status, corporate organisation, their investment managers and investment advisers, the offering and the Tax Grant requested under the Incentives Code (if any).

OCIF Regulation 9461

On 15 May 2023, OCIF enacted Regulation No. 9461 as a means of increasing oversight of private equity funds in Puerto Rico. Among other inspection and compliance requirements imposed by Regulation 9461, one of its main focuses is to compel private equity funds to provide OCIF with the same periodical reports and information required for investors under the Incentives Code. Additionally, Regulation 9461 imposes certain penalties and fines for non-compliance with its provisions. Regulation 9461 therefore drives forward OCIF's interest in monitoring and regulating private equity funds and the surrounding regulatory environment.

4. Due Diligence

4.1 General Information

The level of legal due diligence required in Puerto Rico normally varies, but there is certain information that is generally requested, mostly consisting of confirmatory verifications and validations. This means that, when the investment is to be made by the investors and the fund, they should very much be assured of their decision to move forward in the absence of any new material findings.

The key purpose for legal due diligence in private equity transactions is to corroborate assumptions made by the buyer in arriving at a certain valuation, and to substantiate that the target investment is not exposed to large unidentified liabilities or contingencies, and to thoroughly evaluate the target investment's structure and compliance with applicable laws and regulatory frameworks. A due diligence exercise typically covers the following:

- general corporate information;
- governmental and regulatory documents;
- financial documents;
- litigation documents;
- material contracts;
- real estate and assets;
- environmental matters;
- employee compensation and benefit documents;
- intellectual property;
- tax matters; and
- insurance.

4.2 Vendor Due Diligence

Vendor due diligence is not a common feature of private equity transactions in Puerto Rico.

5. Structure of Transactions

5.1 Structure of the Acquisition

Most acquisitions by private equity funds are typically carried out by private stock or membership interest purchase agreements. Other acquisitions by private equity funds are performed by acquiring the debt of the target company, by issuing new debt to the target company and/or by entering into debt that converts to ownership of the target company (eg, convertible promissory notes). Furthermore, acquisitions by private equity funds are commonly structured by using a special purpose vehicle (SPV), which will be the entity directly responsible for the purchase of the investment or the issuance of the debt.

5.2 Structure of the Buyer

As a general rule, funds that will target both their investments and investor base in Puerto Rico are organised as limited liability companies (LLCs). LLCs organised in Puerto Rico are taxed as corporations by default. However, the Puerto Rico Internal Revenue Code of 2011, as amended (PR IRC), allows LLCs to elect to be treated as partnerships or disregarded entities for income tax purposes, even if the LLC has only one member. As with tax elections made pursuant to the IRC, the election to be taxed as a partnership under the PR IRC allows funds to be transparent for Puerto Rico tax purposes, making the members the parties responsible for the tax liability instead of the fund.

Furthermore, the PR IRC provides that every LLC that is treated as a partnership by reason of its election or provision of law or regulation under the IRC, or the similar provision of a foreign country, or whose income and expenses are attributed to its members for federal income tax purposes or those of the foreign country, will be treated as a partnership for the purposes of the PR IRC, and will not be eligible to be taxed as a corporation.

As mentioned in **5.1 Structure of the Acquisition**, most private equity funds tend to use SPVs in the transaction, thereby separating the fund from the target investment. The private equity fund backing the SPV buyer is typically structured as a "qualifying private fund" exempt from registration under SEC Rule 203(m)-1. The term "qualifying private fund" refers to any private fund that is not registered under Section 8 of the Federal Investment Company Act of 1940, (as amended) (ICA), and has not elected to be treated as a business development company pursuant to Section 54 of the ICA.

It is common for the general partners/members to manage the acquisition (or sale) documentation. As the general partners/members oversee the day-to-day operations of the fund and manage the portfolio companies, they will lead the acquisition (or sale). Depending on the complexity of the transaction, on some occasions the general partners/members engage the investment adviser of the fund or a third-party subject matter expert adviser for additional support during the due diligence process. From a documentation standpoint, very few general partners/members or investment advisers have sufficient expertise to draft and review the transactional documents and, therefore, a law firm should be hired to assist in the complex document drafting.

5.3 Funding Structure of Private Equity Transactions

Generally, private equity deals are financed through capital contributions in the fund, either directly by the limited partners/members in their personal capacity or by a SPV wholly owned by the limited partners/members. Typically, the fund provides investors with an approximate tar-

get for the fund size and the minimum amount of investment that must be committed by the investors prior to becoming partners/members in the fund (ie, the capital commitment). Once the fund determines the investment it wishes to pursue, the general partner/member or investment adviser will notify the limited partners/members of the amount of capital that they must provide the fund (ie, the capital call) and the timeframe in which they must provide it.

The capital call should not exceed the capital commitment made by the limited partners/members, unless the limited partners/members and the fund reach an agreement to do so. Once the fund has sufficient funds, it deploys them in pursuit of the investment. Most private equity deals are geared towards the fund obtaining a majority ownership interest in the investment, debt issuance or a hybrid of both through what is known as a mezzanine financing. Even though private equity deals have become more competitive in the past twelve months, because of the amicable environment in Puerto Rico with the availability of tax incentives and overall benefits to both investors and sponsors, there has been no major evolution in the equity deals tendencies, with the status quo proving a trusted method that provides a consistent flow of capital and deal-making capacity.

5.4 Multiple Investors

Deals involving a consortium of private equity sponsors are not common in Puerto Rico, but co-investment by other investors, including corporate investors, alongside the private equity fund is very common. Of late, the majority of private equity fund sponsors are requesting the ability to offer co-investments as an attractive element of their structures, during the organisation stage of the fund. For example, co-investments tend to provide private equity firms with more flexibility on the terms and conditions of a particular transaction.

Private equity firms can have more capital available to invest in other projects rather than in a single transaction. Co-investments may also improve relationships with investors and the distribution of the investment risk.

For co-investors, the co-investment transaction may allow exposure to additional information and access to due diligence or materials that would not otherwise have been available solely to the private equity fund. Co-investments can also help the co-investor make better decisions and adjust their broader portfolio to best fit their investment needs.

Another advantage is that an institutional investor may receive better fee arrangements in the co-investment special purpose vehicle compared to investing in the main private equity fund. For example, a private equity firm that may wish to attract institutional investors could reduce fees.

Lastly, co-investors are typically limited partners or their affiliates alongside the general partner/member by way of passive stakes by the co-investors and where the fund and its limited partners/members are already investors. In some limited circumstances, external co-investors operate alongside the general partner of the fund by way of passive stakes.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

The predominant form of consideration used in private equity transactions in Puerto Rico is cash. Earn-outs and deferred consideration are

not common features of private equity transactions in Puerto Rico. However, some private equity funds opt to implement a milestone approach to investment where a second larger investment is made in a company once it has achieved certain performance metrics. There has recently been an increase in in-kind investment in private equity funds as the benefits of these types of investment have become more acceptable from a government agency standpoint, such as the OI and OCIF.

The involvement of a private equity fund may affect the type of consideration mechanism used, depending on whether the fund has elected to operate with a Tax Grant under the Incentives Code and whether the partners in the fund hold individual Tax Grants also issued under the Incentives Code. If the fund and the partners do hold Tax Grants, the fund will mainly target income streams covered under the corresponding Tax Grants.

Historically, a private equity buyer would not usually require enhanced or additional protections when making an investment but recently this has begun to change, as private equity buyers are starting to request the same enhanced protections typically used by institutional buyers. Corporate buyers will typically request collateral and other types of security instrument to protect their investment.

6.2 Locked-Box Consideration Structures

The vast majority of private equity transactions are based on locked-box considerations, but no interest is charged on leakage.

6.3 Dispute Resolution for Consideration Structures

Generally, dispute resolution mechanisms are in place for all types of private equity transactions. For example, whether resorting to alternative dispute resolution mechanisms under the rules of the American Arbitration Association (AAA) or the more traditional approach of resolving disputes through the judicial route, dispute resolution mechanisms are commonplace in private equity transactions.

6.4 Conditionality in Acquisition Documentation

The typical conditions to closing are as follows:

- regulatory approvals, as may be required;
- the approval of certain contractual counterparties;
- the conversion of convertible instruments; and
- corporate resolutions approving the transaction.

Material adverse effects provisions are very common in private equity transactions, particularly when the transaction is not designed as a simultaneous sign and close.

Third-party consents are generally requested for closing a private equity deal, when material contracts are involved that require consent for assignment or when a change of control occurs. This is more common in certain industries, such as distribution, services, etc.

Specific consideration must be given by private equity funds when investing in entities that hold preferential Tax Grants. Subject to the amount of ownership being purchased by the private equity fund, prior consent from the OI may be required to avoid the risk of having the Tax Grant revoked.

6.5 "Hell or High Water" Undertakings

"Hell or high water" provisions are not usually accepted by a private equity-backed buyer. The burden is usually placed on the seller's side. Additionally, the new EU FSR regime does not feature in negotiations of these types of undertakings.

6.6 Break Fees

Break fees are not common in Puerto Rico but may be agreed to in certain scenarios involving publicly traded buyers.

6.7 Termination Rights in Acquisition Documentation

A private equity seller or buyer can usually terminate an acquisition agreement in the following circumstances:

- when the deal has not closed by a certain "drop dead" date;
- when third-party or required government consents are not granted or obtained; or
- for reasons stemming from the due diligence.

6.8 Allocation of Risk

Transactions where the seller is a private equity fund and the buyer is another private equity fund are not common in Puerto Rico at this time but the market is likely to develop and require these types of transactions.

6.9 Warranty and Indemnity Protection

A private equity seller normally provides typical title, no liens and authority warranties to a buyer upon an exit. The management team provides business representations to a buyer on exit. It is customary for a cap to be placed on liability for business warranties, but fundamental warranties are either uncapped or capped at the purchase price. Full disclosure of the data room is typically not allowed against the warranties. Typical limitations on liability for warranties in Puerto Rico include baskets, caps and sunsets.

6.10 Other Protections in Acquisition Documentation

Indemnities are generally the only protection provided to private equity buyers and sellers. Insurance is not common, and escrows are only considered when a corporate buyer is involved.

6.11 Commonly Litigated Provisions

Litigation is not common in connection with private equity transactions in Puerto Rico. However, in the limited scenarios where there have been some litigation proceedings, these revolved around certain warranties and representations regarding funding that were in dispute.

7. Takeovers

7.1 Public-to-Private

Public-to-private private equity transactions are not common in Puerto Rico.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Under the PR IRC, partnerships (including funds) must file an Informative Income Tax Return for Pass-Through Entity, and their income flows through and is taxed to the partners. The partnership must also make estimated tax payments equal to 30% of any taxable income that is subject to tax at regular rates (if any). The fund must also make the tax payments that correspond to the income that is subject to the preferential tax rate applicable to any taxable income that is subject to a preferential tax rate under the PR IRC.

The estimated tax payments may be claimed by the partners as a credit on their annual Puerto

Rico Income Tax Return. Accordingly, the estimated tax payments are not an additional tax, but merely a prepayment of the partner's income taxes.

The fund must also provide each of its partners with an informative return detailing all the information required by the partner for the purposes of completing their income tax return.

The income tax return must include audited financial statements, including certain supplementary information established by law, prepared by a certified public accountant who is licensed to practice in Puerto Rico. This requirement only applies to funds with a gross income exceeding specific thresholds provided in the PR IRC.

Furthermore, funds that operate with a Tax Grant must provide audited annual reports to their partners, including audited financial statements prepared under the Generally Accepted Accounting Principles (GAAP), as well as an unaudited report on the performance of individual portfolio companies, and a compliance certificate which confirms the private equity fund's compliance with the terms and conditions of the Tax Grant. Quarterly unaudited financial statements must also be provided to partners.

7.3 Mandatory Offer Thresholds

Private equity funds that do not operate under the rules of the Incentives Code do not have a mandatory offer threshold. However, those private equity funds that elect to request a Tax Grant under the Incentives Code must continually maintain a minimum of USD10 million in capital and/or duly documented legal commitments of capital contributions even if not yet received. The private equity fund that elects to request a Tax Grant under the Incentives Code must secure the capital and/or legal commitments within 24 months after the first issuance of the fund's securities.

7.4 Consideration

Cash is the most common form of consideration used in Puerto Rico. However, securities have recently also started to be used as compensation.

7.5 Conditions in Takeovers

Takeovers are not common in Puerto Rico.

7.6 Acquiring Less Than 100%

Squeeze-out mechanisms are not common in Puerto Rico.

7.7 Irrevocable Commitments

It is not common to obtain irrevocable commitments to tender or vote from the principal shareholders of a target company.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentivisation of the key management team is a common feature of private equity transactions in Puerto Rico. The key management team is usually provided equity depending on their expertise and their role in the company and industry sector.

8.2 Management Participation

Management participation is typically structured as sweat equity subject to vesting. Managers will usually subscribe for ordinary equity or a tracking phantom equity that will follow the performance of a particular metric. A cliff and/or vesting schedule will also be included in the management equity (see **8.3 Vesting/Leaver Provisions**).

8.3 Vesting/Leaver Provisions

Leaver provisions for key management shareholders are typically included in Puerto Rico to attract and retain top talent in many private equity funds, especially in the tech sector. The typical leaver provisions for management shareholders are:

- death;
- permanent disability or permanent incapacity through ill health;
- permanent disability or permanent incapacity through ill health of the executive's spouse or child;
- retirement (at normal retirement age);
- redundancy;
- unjustifiable dismissal by the company; and
- on some occasions, dismissal by the company where the executive has failed to meet certain performance expectations.

A typical vesting clause will usually last for four years and have a one-year cliff.

8.4 Restrictions on Manager Shareholders

One of the most used restrictive covenants agreed to by management shareholders is a non-compete agreement. In Puerto Rico, the courts often disfavour non-compete clauses, as Article II sec. 16 of the Constitution of Puerto Rico recognises the right of every worker to choose his or her occupation and freely resign. To protect this liberty of choice, Puerto Rico courts have carefully interpreted non-compete clauses and imposed rigorous requirements for their validity. When these are not met, the contract will most likely be deemed invalid and unenforceable.

Valid non-compete clauses require the employer to have a legitimate interest in the contract – ie, the business would be substantially affected if the employer does not receive protection under a non-compete agreement. The scale of this interest is measured, considering the position of the manager within the company. The existence of the manager's interest will be directly related and reliant on the manager's position in the company, and whether they compete with the company in the future.

The extent of the prohibition must correspond to the interest of the company, regarding restriction terms or affected customers. The purpose of the ban should be limited to activities like those conducted by the employer and does not have to be limited to specific functions. The term of the non-compete agreement should also not exceed 12 months, understanding that any additional time is excessive and unnecessary to adequately protect the employer.

In terms of the reach of the prohibition, the contract must specify the geographic boundaries and/or affected customers. The geographical area to which the restriction applies should be limited to the area strictly necessary to prevent real competition between the employer and employee. When the non-compete clause concerns customers, it should refer only to those who personally attended the employee for a reasonable period before leaving or in a period immediately preceding the exit of the manager. These elements are evaluated in light of the nature of the industry involved and the possible related public interest.

Additionally, the company must offer something to the manager in return for signing the non-compete agreement, such as a promotion, additional benefits at work or the enjoyment of any similar substantial changes in employment conditions, including a manager keeping a posi-

tion after a change in ownership of the company when another consideration also applies.

As with any contract, non-compete agreements must have the essential elements for validity: consent, object and cause. However, it is a strict requirement that the managers freely and voluntarily sign the non-compete agreement. Undue pressure or coercion by the company would render the non-compete agreement invalid and unenforceable.

In summary, the elements of a valid non-compete agreement in Puerto Rico are as follows:

- the company must have a legitimate interest in the agreement;
- the scope of the prohibition in the non-compete agreement must fit the company's interest but not exceed 12 months;
- the company will offer a consideration in exchange for the employee signing the non-compete agreement, other than mere job tenure;
- non-compete agreements must be valid contracts; and
- non-compete agreements must be in writing.

Despite these requirements, after the Federal Trade Commission (FTC) of the USA adopted its final rule in which it banned non-compete agreements across the United States (the Final Rule), as of 4 September 2024, the validity of some of these non-compete agreements (Non-Competes) will come into question. However, with the Final Rule being challenged across the country, the regulatory landscape is unclear, with the FTC's authority to enact the Final Rule being called into question.

Non-Competes that involve a senior executive and upper management will also still be valid if certain compensation and policy-making thresholds are met. Private equity funds that adopt Non-Competes with upper management may therefore be covered by the exception provided by the Final Rule if all the requirements are met. Regardless, despite the uncertainty surrounding the validity of non-compete agreements, the situation should be monitored for the near future and beyond.

8.5 Minority Protection for Manager Shareholders

Management typically does not have rights under minority protection provisions.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

The most common control mechanisms awarded to limited partners in the private equity fund on specific portfolio investments are board appointment rights and information rights. However, most of the board appointment rights and information rights are granted at the private equity fund level and not at the portfolio investment level. However, there have been instances where limited partners/members in the private equity fund are actively negotiated and are granted these board appointment and information rights at the portfolio investment level, but it is not the actual norm.

9.2 Shareholder Liability

It would be extremely difficult for a private equity fund majority shareholder/member to be held liable for the actions of its portfolio company, as two corporate veils would have to be pierced. However, these corporate veils may be pierced by a court of law in an extreme case where both

the private equity fund and the portfolio company are part of a scheme to commit fraud.

10. Exits

10.1 Types of Exit

In Puerto Rico, the typical holding period for private equity transactions is between three and six years. The most common exit route is a trade sale, which allows all management and institutional investors to be entirely cashed out and focused on new ventures. Dual track exits are uncommon in Puerto Rico. There has recently been an interest in rolling on investment into a follow-on fund as opposed to an exit once the term to commence winding down of the fund is close.

Private equity sellers typically reinvest upon exit, depending on the given term of the private equity fund and any reinvestment restrictions. Where within 90 days from the sale, the investor reinvests the entire gross income generated in a Puerto Rico private capital fund, the capital gains realised by the investors of those funds will not be subject to any income tax.

10.2 Drag and Tag Rights

Drag rights are agreed to in private equity investments. The typical drag threshold for any person(s) selling is that they hold more than 50% ownership.

Tag rights are also typical in private equity investments. The typical tag threshold for any person is that they hold more than 50% ownership.

10.3 IPO

Because of the limited number of IPOs in the Puerto Rico market, exit by means of an IPO is not a common practice. However, the trends affecting lock-ups and relationship agreements would likely follow those on the US mainland.

SINGAPORE

Law and Practice

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RAJAH & TANN ASIA

1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

Singapore is a key hub for fund managers and investment entities and continues to serve as an entry point for regional South-East Asian private equity and investment activity.

South-East Asia remains a rich hunting ground as high-growth companies in the region start to mature. Many South-East Asian businesses have restructured to include Singapore-incorporated holding entities and raised capital through these, which has continued to help drive deal flow in Singapore for PE/M&A activity.

Capital markets and treasury conditions remain challenging however, and this has contributed to a marked increase in private credit funds and investment/acquisition transactions structured with private credit components. The challenging capital market environment has also played a part in increasing South-East Asia PE secondary activity.

Special purpose acquisition companies (SPACs) also contributed to deal activity in the region, as South-East Asian unicorns prepare for a capital markets exit, though this is expected to slow down in line with the decline in global SPAC listings in the last couple of years.

1.2 Market Activity and Impact of Macro-Economic Factors

Owing to global geopolitical and macroeconomic developments such as still high interest rates, sanctions, war, inflationary pressures and challenging capital market and treasury conditions, the subdued M&A deal activity witnessed in 2023 has extended into 2024 thus far, at least in comparison to the buoyancy seen in prior years where deal activity reached record-breaking levels.

Singapore's state investor, Temasek, stated in 2021 that it expected to increasingly shape its portfolio in line with four structural trends: digitisation, sustainable living, future of consumption and longer lifespans. This continues to be an accurate description of the trends in investment and M&A activity in 2024. Sectors that continue to see healthy deal interest broadly fall into the above-mentioned categories: digitalisation, technology, data and cybersecurity, renewable energy, energy transition activities, education and healthcare. Given the emergence of commercialised artificial intelligence (AI) in particu-

lar, deal flow and private equity interest in AI software companies and data centres have also seen more activity.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

The following changes to the law, practice and regulations in recent years have either already had an impact on the private equity community and private equity transactions or may do so in the future.

Significant Investments Review Act 2024

The Significant Investments Review Act came into force on 28 March 2024 and applies to both local and foreign investors. The Act sets out a new investment management regime, which seeks to strengthen the resilience of Singapore's economy and enhance Singapore's national security by ensuring the continuity of critical entities. Entities that are critical to the security interests of Singapore, but which are not caught by existing sector-specific legislation, may be designated under the Act ("Designated Entities"). The entities must be incorporated, formed, or established in Singapore; carry out activities in Singapore; or provide good and services to persons in Singapore.

The inaugural list of Designated Entities was published on 31 May 2024, and includes nine entities which are key providers involved in the petrochemicals industry, manufacturing of defence equipment and security solutions, marine and shipbuilding services, and digital services. Designated Entities are subject to, among other things:

- the requirement to notify or seek approval for certain specified changes in ownership and control;
- the requirement to seek approval for appointment of key officers; and
- restrictions on voluntarily winding up, dissolution or termination.

It should be noted that even if an entity has not been designated, the Minister can review ownership or control transactions involving an entity that has acted against Singapore's national security interests. While the term "national security" is not defined, the inaugural list of Designated Entities provides insight as to the type of functions that are deemed critical to national security.

Good Governance

On 28 February 2024, following on from the conclusion of the consultations on the recommendations made by Singapore's Sustainability Reporting Advisory Committee, the Accounting and Corporate Regulatory Authority (ACRA) and SGX RegCo (the body that undertakes frontline regulatory functions for the Singapore stock exchange) published a response containing a finalised climate reporting and assurance implementation roadmap. The roadmap highlighted that the proposed mandatory climate-related disclosure requirements will apply to:

- issuers listed on the SGX from financial year 2025 onward; and
- large, non-listed companies limited by shares with an annual revenue of at least SGD1 billion and total assets of at least SGD500 million (unless exempted) from financial year 2027.

Further, ACRA and SGX RegCo also stated in their response that a review will be conducted

around 2027 to consider whether the mandatory climate reporting should be expanded to other non-listed companies by around financial year 2030.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Singapore's laws and regulations are in line with those of other major financial centres and private equity investors should be able to navigate them with ease. Singapore is an investor-friendly jurisdiction and consistently ranks as one of the world's most competitive economies according to the World Economic Forum.

There are no general foreign shareholding restrictions in Singapore, apart from in a few tightly regulated industries such as banking, broadcasting and newspaper publishing. Neither does Singapore have a general national security or national interests regime with regard to foreign investment and acquisitions. Notwithstanding the foregoing, the Significant Investments Review Act introduces new layers of regulatory oversight applicable to both foreign and domestic investments, and this should be factored into transaction planning and execution. See **2.1 Impact of Legal Developments on Funds and Transactions** for further detail.

Change of control or shareholding in some target companies may be subject to conditions in their licences (if they are licensed entities) and/or to antitrust regulations, but these are generally in line with antitrust principles that would be familiar to international private equity investors.

Key Regulators Relevant to Private Equity Transactions and the Private Equity Community

Monetary Authority of Singapore

Fund management is a regulated activity under the Monetary Authority of Singapore Act, for which a Capital Markets Services (CMS) licence is required – unless one of the available licensing exemptions applies. Typically, the manager of the funds in Singapore must either be a Registered Fund Management Company (RFMC) or hold a CMS licence.

Singapore Exchange and Securities Industry Council

Public-to-private transactions need to comply with the regime under the Singapore Code on Takeovers and Mergers (the "Takeover Code"), which is administered by the Securities Industry Council (SIC), and voluntary delistings under the SGX Listing Rules.

Competition and Consumer Commission of Singapore (CCCS)

The Competition and Consumer Commission of Singapore (CCCS) is the regulator for competition law and regulations.

Relevant Laws/Regulations

Private equity players will often encounter the following legislative provisions in the course of their business compliance or in transactions:

- the Securities and Futures Act (SFA);
- the Takeover Code;
- the SGX Listing Rules – these apply to all companies listed on the SGX (whether Mainboard or the secondary "Catalist board") and require controlling shareholders to notify listed companies of:
  (a) any share-pledging arrangements; and
  (b) any event that may result in a breach of

loan covenants entered into by the listed company, which may impact acquisition financing terms for buyouts;

- the Competition Act – generally, anti-competitive agreements or any M&A that substantially lessen competition are prohibited under the Competition Act and require clearance/consent from the CCCS;
- the Companies Act – this is applicable to all incorporated companies in Singapore;
- the Employment Act – this applies where the transfer of employees is involved or where it is necessary to enter into employment agreements with key employees; and
- sector-specific legislation the target may be subject to.

4. Due Diligence

4.1 General Information

Typically, detailed due diligence is carried out by private equity bidders covering the usual areas, such as commercial, financial, tax, legal, insurance, compliance and environment. Materiality and scope depend on the private equity investor's risk assessment and financing requirements, the complexity of the target's business, and the timeframe for the particular acquisition.

Legal due diligence usually covers the following areas:

- corporate information and records;
- regulatory approvals;
- licences or permits;
- material contracts;
- any change of control or change in shareholding restrictions;
- information relating to assets (including title to real estate), IP rights and IT;
- employee and labour law matters;
- litigation that the target is involved in (including customary litigation and court searches);
- charges and encumbrances registered against the target's assets; and
- ESG, responsible investing and compliance matters, such as environmental laws, data protection and anti-bribery and corruption (although these will typically be conducted with the help of specialist advisers).

4.2 Vendor Due Diligence

Vendor due diligence (VDD) and reliance on VDD reports is not as common in Singapore as it is in other jurisdictions (eg, the UK and Europe), but there has been a growing trend towards this in recent years – especially for competitive auction deals run by private equity sellers (who tend to run better-organised sale processes than less sophisticated sellers).

Given that VDD is not an established common practice for M&A deals generally, there is also less familiarity with and less acceptance of VDD reports. Bidders typically still conduct fairly extensive due diligence, even where a VDD report is available.

Where there is VDD, the starting position is usually for the VDD reports to be provided on a non-reliance basis to bidders, although there is a gradual increase in transactions where the successful bidder/buyer will be granted reliance.

5. Structure of Transactions

5.1 Structure of the Acquisition

Acquisition structures are usually determined by the nature of the target and its assets rather than the identity of the buyer (whether private equity or otherwise).

Private/Unlisted Companies

For the acquisition of private/unlisted companies, such acquisitions will be by way of private treaty sale and purchase agreement (whether through bilateral negotiations or through an auction process). Generally speaking, share acquisitions are more common than asset acquisitions.

Public/Listed Targets

For public/listed targets, acquisitions (assuming control deals) will either be by way of general offers (voluntary being more common than mandatory) or court-approved schemes of arrangement. As private equity transactions are often leveraged, the "all-or-nothing" nature of schemes of arrangement lends itself better to debt "pushdown" and is often favoured where there is reasonable confidence that the necessary approval thresholds can be met.

5.2 Structure of the Buyer

It is common for the fund making the acquisition to set up a holding company that, in turn, holds a special-purpose vehicle as the buyer entity (Bidco). Representatives of the fund shareholder will be appointed to the board of the Bidco, but it is the Bidco that contracts with the seller. The fund itself will not usually be involved in or party to any contractual documentation (other than perhaps an equity commitment letter).

5.3 Funding Structure of Private Equity Transactions

Financing

Private equity deals in Singapore are normally financed by traditional bank financing and banks are generally willing to support leveraged finance transactions where the track record of the sponsor and the quality of the target assets are not an issue. For leveraged buyout structures, Singapore abolished the concept of financial assistance for private companies (which facilitates debt pushdown) in 2015, but financial assistance prohibitions (with exemptions) continue to apply to public companies and their subsidiaries.

For public takeovers and mergers, it is generally not permitted for business combinations to be conditional on the bidder obtaining financing.

Commitment Letter

For acquisitions of private/unlisted targets, equity commitment letters are common, although satisfactory evidence of debt financing will also often be expected in competitive processes. A financing condition is subject to negotiations between the buyer and seller, although not typically included in transaction documentation.

For acquisitions of public/listed targets that are governed by the Takeover Code, the firm intention to undertake an offer requires an unconditional confirmation by the offeror's financial adviser (or by another appropriate third party) that the offeror has sufficient resources available to satisfy full acceptance of the offer. Accordingly, the financial adviser to the offeror will need to conduct due diligence; and review and be satisfied with the sources of financing. An equity commitment letter may not suffice, as these increasingly need to be supplemented by debt financing documents that are capable of being drawn on if necessary.

Stakes

Private equity deals see a good mix of control deals versus minority investments. Traditionally, private equity deals have seen private equity funds taking a majority or control stake but there is now also a trend towards significant minority investment deals. Early round venture capital investments (including by private equity funds) have also increased in pace and volume.

These minority/partnership investments in buyout transactions could be a reflection of the Asian private equity market, where intrinsic value is tied to the operational know-how and relationships of family owners and family-linked conglomerates, even though there is a desire for professional managers to take the businesses forward.

5.4 Multiple Investors

Consortium Arrangements

Private equity deals (especially the higher-value ones) are frequently entered into by a consortium, comprising private equity sponsors but also other investors investing alongside them.

Broadly speaking, it is more common to see existing controlling shareholders/management as co-investors in these consortiums than other limited partners or private equity sponsors as direct investors (rather than through private stakes). However, there are notable high-value exceptions, such as the acquisition and privatisation of Global Logistic Properties Limited in 2017 by Nesta Investment Holdings Limited (which is controlled by a consortium comprising various investors, including HOPU Logistics Investment Management Co Ltd, Hillhouse Capital Logistics Management Ltd, Bank of China Group Investment Limited, and Vanke Real Estate (Hong Kong) Company Limited) by way of a scheme of arrangement in what was Asia's largest-ever private equity buyout.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Transaction Terms: Private Acquisitions

Consideration structures which entail post-completion audits and consequential purchase-price adjustments are more common in the sale of private companies than locked-box mechanisms, although private equity sellers would usually prefer and insist on the latter.

Earn-outs are not typically used where the buyer and the seller want a clean break after the acquisition is complete. A private equity fund looking to divest a portfolio entity at the tail-end of its fund cycle, for example, will not be inclined to accept earn-out as a form of deferred payment. Conversely, where private equity investors are buyers, earn-outs to incentivise management sellers would be common.

Generally speaking, private equity buyers are less likely to provide protection for consideration (whether in the form of a guarantee or enforceable commitments) than a corporate buyer would.

6.2 Locked-Box Consideration Structures

Interest on leakage for locked-box consideration remains a negotiated point in most deals and there is no established norm, especially because locked-box mechanisms are not that widespread in the first place. However, in most cases it is unlikely that interest would be charged.

6.3 Dispute Resolution for Consideration Structures

In locked-box and completion accounts adjustments, it is fairly common for sale and purchase agreements to provide for resolution of disputes via expert determination by an independent accountant, rather than resort to a dispute resolution mechanism.

6.4 Conditionality in Acquisition Documentation

Conditionality of deals is usually a heavily negotiated area and there is no "standard" norm.

Private equity sellers will usually insist on certainty of transaction and will not agree to conditions other than those that are absolutely necessary or mandatory/regulatory.

Financing conditions are generally resisted and are relatively rare, whereas limited material adverse change clauses are usually agreed to.

6.5 "Hell or High Water" Undertakings

"Hell or high water" undertakings are not common in Singapore and private equity backed buyers will resist this very strongly.

6.6 Break Fees

Break fee arrangements are permitted but uncommon. Reverse break fees are even more rare in Singapore.

For private M&A transactions, parties should be mindful that a proposed break fee may constitute a penalty, and consequently not be enforceable if it does not represent a genuine estimate of the loss suffered by the innocent party.

For public deals, there are restrictions and prescribed requirements to be met in the Takeover Code for a listed target to agree to any break fees and certain safeguards must be observed. Such safeguards assume that a break fee must be nominal, normally not more than 1% of the value of the target calculated by reference to the offer price. The directors of the target company (both public and private) must also consider their fiduciary duties in agreeing to such break fees, as well as the possible breach of any financial assistance prohibition under the Companies Act. For a public transaction, the target board and its financial adviser would also be required to provide written confirmations to the SIC, including that (i) the break fee arrangements were agreed as a result of normal commercial negotiations and (ii) they each believe the break fee to be in the best interests of the offeree company shareholders. The break fee arrangement must be fully disclosed in the officer announcement and the offer document, and the SIC should be consulted at the earliest opportunity where a break fee or similar arrangements are proposed.

While it is generally open to bidders to propose deal security measures (such as break fees), where the Takeover Code applies, the target company should note its duty under the Takeover Code to not undertake any deal security measures that could frustrate a bona fide offer or deny its shareholders an opportunity to decide on that offer's merits.

6.7 Termination Rights in Acquisition Documentation

Private equity buyers and sellers are usually extremely focused on deal certainty and termination rights are typically heavily resisted.

Sale and purchase agreements typically contain a longstop date by which the closing conditions must be fulfilled, failing which the agreement will terminate. However, as mentioned previously, the conditions and necessity of said agreement will usually be heavily negotiated and any attempt at a "back-door" termination will generally be viewed with suspicion. Longstop dates are typically between three to six months from signing date.

The right to terminate for breach of pre-closing undertakings or representations/warranties will usually be resisted and at the very least pegged to some material thresholds.

It should be noted that the termination of the purchase agreement is subject to the SIC's approval in a going-private transaction subject

to the Takeover Code, even when the condition giving rise to the termination right has been triggered.

6.8 Allocation of Risk

Parties are generally free to negotiate the representations, warranties and indemnities. The scope of these varies widely from transaction to transaction and will depend on the relative bargaining power of the parties. Private equity sellers will want to minimise their continuing/residual liability on the sale of a portfolio company and, generally, the risks they are prepared to accept (whether in the form of warranties or indemnities or covenants) will be lower compared to corporate sellers.

See also **6.9 Warranty and Indemnity Protection** and **6.10 Other Protections in Acquisition Documentation**.

6.9 Warranty and Indemnity Protection

Warranties

A private equity seller will usually give fundamental warranties pertaining to title, capacity and authority, but willingness to provide extensive business warranties will depend on the extent of participation and the involvement of management. 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 the warranties, subject to limited liability caps of between 10% to 30% of the consideration. See also **6.8 Allocation of Risk**.

Limits on Liability

Customary limitations on a seller's liability under a sale and purchase agreement include:

- for fundamental warranties – capped at an amount equal to or less than the purchase price;
- for other warranties, typical caps between 10% to 30% of the consideration;
- a de minimis threshold (normally about 0.1% of the purchase price for each individual claim and 0.5% to 1% of the purchase price for the aggregate value of such claims);
- a limitation period of 18–36 months for non-tax claims and between three to six years for fundamental warranty and tax claims; and
- qualifying representations and warranties with disclosure contained in the disclosure letter and all information in the data room.

6.10 Other Protections in Acquisition Documentation

Warranty and Indemnity Insurance

The use of warranty and indemnity (W&I) insurance to mitigate deal risk for private equity firms has gained traction in recent years and is now widely accepted (in fact, it is a prerequisite for most private equity parties). On the sell-side, it bridges the gap on the extent of warranties coverage and liability caps; on the buy-side, it enhances the attractiveness of the private equity investor's bid in competitive bid situations. Seller-initiated, limited or no recourse W&I insurance appears to be becoming increasingly popular, as more private equity sellers seek clean exits by requiring buyers to take out buy-side insurance as stapled deals (commonly known as the sell-buy flip).

Target Company Management's Involvement

A private equity sponsor will also typically look to greater commitment and support for the transaction from the management of the target company to ensure management continuity. As such, it is not uncommon to find private equity sponsors insisting that the terms of the trans-

action give them the right to negotiate with the existing management of the target company or offer them the opportunity to participate with an equity stake in the bidding vehicle or enter into new service agreements. See **8. Management Incentives** for more on typical management participation terms.

Escrows and Security

Where known risks are identified, an escrow account may be set aside from the consideration to satisfy such claims and to secure any indemnity obligations; however, it is extremely rare for any private equity seller to agree to provide any such escrow or security.

6.11 Commonly Litigated Provisions

There do not appear to have been many litigation suits in connection with private equity M&A deals in Singapore.

7. Takeovers

7.1 Public-to-Private

Take-privates are common in Singapore. As companies listed on the SGX often trade at a discount to their book values, delistings have outnumbered listings on the SGX for the past five years.

Many of these take-privates are backed by private equity investors (often as part of a consortium with existing controlling shareholders).

However, due to changes in the voluntary delisting regime and compulsory acquisition provisions, it is expected that privatisations will become increasingly difficult to structure. It is therefore also expected that the pace will slow somewhat.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

For listed entities, a substantial shareholder (5% or more) needs to give notice to the listed corporation within two business days of:

- their interest;
- any change in the percentage level of their interest; or
- when they cease to be a substantial shareholder.

The issuer is then required to make the corresponding disclosures via SGX announcements. Substantial shareholders include persons who have the authority to dispose of – or exercise control over the disposal of – the relevant securities, and deemed interests are included in such securities. It should be noted that fund managers and their controllers would have to disclose their interests under this regime.

7.3 Mandatory Offer Thresholds

Under Rule 14.1 of the Takeover Code, the thresholds for triggering a mandatory general offer are as follows:

- where any person acquires, whether by a series of transactions over a period of time or not, shares that (added together with shares held or acquired by persons acting in concert with them) carry 30% or more of the voting rights of a company; or
- any person who, together with persons acting in concert with them, holds not less than 30% but not more than 50% of the voting rights and such person, or any person acting in concert with them, acquires additional shares within any six-month period that carry more than 1% of the voting rights.

Persons who trigger the thresholds must extend offers immediately to the holders of any class of share capital of the company that carries votes and in which such person, or persons acting in concert with them, hold shares. Each of the principal members of the group of persons acting in concert with such person may, according to the circumstances of the case, have an obligation to extend the offer as well.

7.4 Consideration

For voluntary and partial offers, the offeror can offer cash or securities (or a combination of the two) as consideration for the shares of the target, except for in certain limited instances under the Takeover Code where a cash or securities offer is required.

For mandatory offers, the offeror must offer cash or a cash alternative for the shares of the target.

7.5 Conditions in Takeovers

The ability to introduce offer conditions is limited by Takeover Code restrictions.

Mandatory Offer

In the case of a mandatory offer, the only condition that can be imposed – apart from merger control clearance by the CCCS – is on the minimum level of acceptance.

Voluntary or Partial Offer

In the case of a voluntary or partial offer, conditions cannot be attached where their fulfilment depends on the subjective interpretation or judgement of the bidder. If this lies in the bidder's hands, the SIC should be consulted on the conditions to be attached. Even where a condition is permitted, SIC consent is required to revoke a general offer that has been announced in case of non-fulfilment of conditions.

Cash Offer

Financing conditions would not generally be permitted. Where the offer is for cash or includes an element of cash, the bidder must have sufficient financial resources unconditionally available to allow it to satisfy full acceptance of the offer before it can announce the offer. The SIC requires the financial adviser to the bidder or any other appropriate third party to confirm this unconditionally.

Exclusivity Clauses

Deal protections could include "no-shop" or exclusivity clauses.

Break Fees

The provision of a break fee could be included subject to Takeover Code restrictions. This break fee will be payable should certain specified events occur, such as:

- a superior competing offer becoming or being declared unconditional with regard to acceptance within a specified time; or
- the board of the target public company recommending to the shareholders that they should accept a superior competing offer.

7.6 Acquiring Less Than 100%

Under Section 215(1) of the Companies Act 1967 of Singapore, an acquirer can exercise the right of compulsory acquisition to buy out the remaining shareholders of a listed company if it receives acceptances pursuant to the general offer in respect of not less than 90% of the listed company's shares.

On 1 July 2023, the criteria for computing the 90% threshold requirement were revised to expand the scope of shareholders whose shares will be excluded from the computation. The scope of exclusion now covers any shares held

as treasury shares and those shares already held at the date of the offer by the following:

(a) the offeror (or the offeror's related corporations);
(b) a nominee of the offeror (or its related corporations);
(c) a person who is accustomed or is under an obligation whether formal or informal to act in accordance with the directions, instructions or wishes of the offeror in respect of the target company;
(d) the offeror's spouse, parent, brother, sister, son, adopted son, stepson, daughter, adopted daughter or stepdaughter;
(e) a person whose directions, instructions or wishes the offeror is accustomed or is under an obligation whether formal or informal to act in accordance with, in respect of the target company; or
(f) a body corporate that is "controlled" by the offeror or a person mentioned in points c), d) or e) above ("Excluded Persons").

A body corporate is "controlled" by the offeror or Excluded Persons if:

- the offeror or Excluded Persons is/are entitled to exercise or control the exercise of not less than 50% of the voting power in the body corporate or such percentage of the voting power in the body corporate as may be prescribed, whichever is lower; or
- the body corporate is, or a majority of its directors are, accustomed or under an obligation, whether formal or informal, to act in accordance with the directions, instructions or wishes of the offeror or Excluded Persons.

Acquisitions of the listed company's shares outside the general offer may be counted towards the 90% squeeze-out threshold, provided that:

- these acquisitions are made during the period when the general offer is open for acceptances, up to the close of the general offer;
- the acquisition price does not exceed the offer price; or
- the offer price is revised to match or exceed the acquisition price.

If a bidder fails to achieve the squeeze-out thresholds, its ability to seek additional governance rights will depend on whether it can at least achieve delisting of the target. Otherwise, listing rules may be restrictive in respect of additional governance rules. In the context of a public takeover offer, no additional rights are granted to a shareholder by reason of a significant shareholding. Debt push-down will also be more difficult as long as the target remains a public company (ie, one with more than 50 shareholders) as there are legislative provisions which prohibit a target from providing financial assistance (direct or indirect) in the acquisition of its own shares (whether pre or post-acquisition). A special resolution (75%) will, inter alia, be required from shareholders to approve such financial assistance.

7.7 Irrevocable Commitments

It is common for a bidder to seek irrevocable undertakings from key shareholders to accept its proposed offer (or to vote favourably) and thereby increase the likelihood of the offer (or scheme) being successful.

Similarly, where shareholders' approval for the sale is required, the private equity buyer may seek irrevocable undertakings from certain existing shareholders to vote favourably.

The undertakings can either be "soft" (which allows an out to the undertaking shareholder if a better offer is made) or "hard" (which does not allow any such out). Where the offer terms are

favourable, "hard" undertakings have become increasingly common.

Given the highly confidential and price-sensitive nature of such transactions, any approach for irrevocable undertakings will need to be handled with sensitivity and the timing carefully judged (with appropriate non-disclosure agreements and wall-crossing measures in place).

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Alignment of management interests with the private equity investor's financial objectives is a key consideration and, therefore, equity incentives are a common feature of private equity transactions.

8.2 Management Participation

The form of management participation varies and could either be ordinary or preferred.

Equity securities may be subject to ratchets measured by key performance indicators. These would usually be subject to restrictions on transfer and claw-back mechanisms, or only exercisable on exit.

For take-private transactions, subject to clearance with the SIC on any "special deals" issues under the Takeover Code, management may be offered the opportunity to participate (with an equity stake) in the bidding vehicle or its holding company, where management agree to swap their shares for equity in the bidding vehicle. As shareholders in the bidding vehicle, the management is likely to be subject to the usual restrictions that a private equity sponsor would expect to impose in terms of voting rights and transferability of shares.

8.3 Vesting/Leaver Provisions

Management equity is commonly subject to good leaver and bad leaver provisions. Vesting periods, as well as any moratorium or restrictions, would usually be for at least a period that coincides with the time anticipated for management to achieve an exit for the private equity sponsor, usually within three to five years.

8.4 Restrictions on Manager Shareholders

Management shareholders generally agree to non-compete and non-solicitation undertakings.

Such undertakings will need to be "reasonable". Restrictive covenants such as non-competition and non-solicitation clauses are generally not enforceable under Singapore law unless and until they are proven to be:

- reasonably required to protect a legitimate proprietary interest of the party seeking to enforce such a covenant;
- reasonable in respect of the interests of the parties concerned; and
- reasonable with regard to the interests of the public.

8.5 Minority Protection for Manager Shareholders

Management may have pre-emption rights to subscribe for fresh equity on the same terms but typically would not have evergreen anti-dilution rights.

The reserved matters list will also usually be kept short and restricted, and the ability of the management team to control or influence the exit of the private equity sponsor will normally be limited.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

Oversight by the private equity fund is usually achieved through a combination of board appointments, veto rights and information rights. Private equity investors typically enjoy veto rights over material corporate actions, including restrictions on further issuances of debt/equity, change of business, winding-up and other 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 capital and/or operational expenditures above a certain threshold, and material acquisitions and disposals.

Directors of the portfolio company appointed by the private equity investor may disclose information received by such directors if such disclosure is:

- not likely to prejudice the portfolio company; and
- made with the authorisation of the portfolio company's board of directors, with regard to all, any class of, or specific information.

9.2 Shareholder Liability

As a fundamental principle of company law, a company is a separate legal entity from its shareholders and its shareholders are not liable for the company's actions. The Singapore courts would not generally pierce the corporate veil. Accordingly, it is unlikely that a private equity investor will be liable for the liabilities of underlying portfolio companies, except in very unusual circumstances.

10. Exits

10.1 Types of Exit

Most exits in recent years have been through trade sales rather than through public offerings.

Holding periods seem to be on the rise and average about five to six years or even more.

Dual-tracked exit processes are only undertaken when private equity sellers are truly unsure which option is more likely to be consummated; however, they are usually keen to end the dual track as soon as possible.

10.2 Drag and Tag Rights

Drag Rights

Drag rights are common in the event of an exit by the private equity investor, but it is less common for the drag to actually be enforced, since interests are usually aligned, and most exits are done on a consensual basis.

Drag thresholds vary but will typically be 50% or more. In transactions where there is a significant minority or institutional co-investor, it could be that a hurdle needs to be achieved before the drag can be activated.

Tag Rights

Tag rights in favour of management and co-investors are not uncommon, but they depend on the bargaining powers of the management shareholders. Institutional co-investors would typically expect a quid pro quo tag right for drag rights.

10.3 IPO

Lock-Up

Moratorium requirements are set out under the SGX Listing Rules for the Mainboard and Catalist respectively.

For the Mainboard

For promoters (which include persons holding 15% or more of the total voting rights in the issuer and their associates, and executive directors with an interest in 5% or more of the issued share capital of the issuer, excluding subsidiary holdings, at the time of listing), the moratorium:

- is for the entire shareholding for at least six months after listing; and
- if the issuer is relying on certain admission criteria, the promoters' shareholding will be subject thereafter to a further lock-up of no less than 50% of the original shareholding (adjusted for bonus issue, subdivision or consolidation) for an additional six months thereafter.

Where a promoter has an indirect shareholding in the issuer, the promoter must also provide an undertaking to maintain the promoter's effective interest in the securities under moratorium during the moratorium period. However, where an indirect shareholding is held through a company which is listed, the promoter's holding in that listed company is excluded from the moratorium.

For investors with 5% or more of post-invitation share capital who acquired and paid for their shares less than 12 months prior to the date of the listing application, their shares will be subject to a six-month lock-up to be given over the proportion of shares representing the profit portion of the shares.

For investors each with less than 5% of the issuer's post-invitation issued share capital who acquired and paid for their shares less than 12 months prior to the date of the listing application, there is no limit on the number of shares that may be sold as vendor shares at the time of the IPO. But if the investor has shares that remain unsold at the time of the IPO, the remaining shares will also be subject to a six-month lock-up to be given over the proportion of shares representing the profit portion of the shares.

For investors who are connected to the issue manager for the IPO of the issuer's securities, their shareholdings will be subject to a moratorium of six months after listing. For the avoidance of doubt, these investors are prohibited from selling vendor shares at the time of the IPO. The aforesaid moratorium and prohibition will not apply to investors that are fund managers where:

- the funds invested in the issuer are managed on behalf of independent third parties;
- the investor and the issue manager have separate and independent management teams and decision-making structures; and
- proper policies and procedures have been implemented to address any conflicts of interest arising between the issue manager and the investor,

subject to the issuer consulting with, and demonstrating to, the SGX that these conditions have been met, to the satisfaction of the SGX.

The SGX retains the discretion to require compliance with the aforesaid moratorium and prohibition where it deems fit.

For Catalist

The Catalist Listing Rules set out moratorium requirements in respect of promoters, investors who acquired and paid for their securities less than 12 months prior to listing, as well as any investors who are connected to the sponsor of the IPO. They are broadly similar to the Mainboard requirements – except that:

- in the case of promoters' shareholdings, at least 50% of the original shareholding (adjusted for any bonus issue, subdivision or consolidation) is required to be subject to a lock-up of six months following the expiry of the initial six-month period after listing where their entire shareholding is locked up; and
- in the case of investors who acquired and paid for their securities less than 12 months prior to listing, they are subject to a 12-month lock-up to be given over the proportion of shares representing the profit portion of the shares.

Post-IPO relationship agreements are not entered into between a private equity seller and the target company.

Trends and Developments

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Rajah & Tann Singapore LLP is a leading full-service law firm and a member of Rajah & Tann Asia – one of the largest legal networks in the region, with more than 1,000 fee earners in South-East Asia and China. A member of the VIMA (Venture Capital Investment Model Agreements) working group, the private equity and venture capital (PEVC) practice is a highly integrated, multidisciplinary group of recognised experts who work closely with other practices across the firm and network. The team has extensive experience in providing comprehensive solutions through every stage of the PEVC investment cycle, including fund establishment and formation, fundraising, buyouts, distressed deals, exit planning, restructuring and financing. Clients include private equity firms, equity investors, funds, founders, start-ups, leaders, banks, sovereign wealth funds, institutional investors, strategic investors, portfolio companies and management teams. The firm has offices in Cambodia, China, Indonesia, Lao PDR, Malaysia, Myanmar, Thailand, Philippines and Vietnam, as well as dedicated desks focusing on Brunei, Japan and South Asia.

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An Overview of the Private Equity Landscape in Singapore

Singapore continues to be a central hub for international private equity (PE) fund managers seeking opportunities in South-East Asia, especially since South-East Asia deal activity is driven through Singapore to a certain extent. South-East Asia is also a key investment destination for global investors aiming to diversify their portfolios. Many international fund managers have already established a presence in Singapore and are now broadening their focus or expanding into new asset classes.

Notwithstanding the challenging climate in 2023, PE activity in Singapore continued to grow in specific sectors, particularly sustainability, the energy transition and consumer-focused areas such as healthcare and education. Investors are increasingly drawn to opportunities that align with global mega-trends and the city-state's strategic priorities.

The aspirational consumer sector is driving investment in premium products and services, reflecting the rising middle class's desire for better quality products and enhanced lifestyles. Consumer-centric sectors such as healthcare and education offer compelling growth prospects and align well with Singapore's long-term vision of sustainable and inclusive economic development.

The healthcare sector remains robust, with significant investments aimed at enhancing service delivery, expanding medical technologies, and meeting the growing demand for quality healthcare. In education, PE is capitalising on the growing demand for diverse and high-quality educational services, from early childhood programmes to advanced professional training.

Within the energy transition sector, PE is fuelling innovations in renewable energy, energy efficiency, and sustainable infrastructure, driven by strong government support and an urgent need for decarbonisation. ESG investment is gaining momentum despite being relatively new and facing challenges such as evolving regulatory requirements for sustainable finance and difficulties in quantifying ESG metrics.

The emergence of commercialised artificial intelligence (AI) is expected to fuel a growing demand for cloud computing and significantly strain data storage resources, making both AI software companies and data centres highly attractive targets. Whilst AI is still in its nascent stages, its development is generally driven by two main forces: large corporations and smaller start-up

companies. These start-ups are typically funded by venture capital, which provides the necessary resources for innovation and growth.

For example, in 2023, Neurowyzr Pte Ltd, a Singapore-based neuroscience and brain capital company which uses discoveries in neuroscience, advanced analytics and AI, to enable early detection, diagnosis, therapy, monitoring and prevention of brain decline, received seed funding led by Jungle Ventures and Peak XV Partners' Surge. Additionally, a group of investors led by Xora Innovation Pte Ltd, the early-stage "deep tech" investing platform of Singapore's Temasek, invested in a series A funding round in Cosmos Innovation Inc, a software company engaged in AI to build next-generation solar and semiconductor technologies.

As the industry continues to mature, we can expect to see an increase in PE deals and M&A activity in the AI space, further fuelling its growth and innovation.

Market performance

According to Bain, South-East Asia's PE market was not immune to the global slowdown in deal activity in 2023. Overall deal value in South-East Asia declined by 39% to USD9 billion for 2023, compared to the previous five-year average (2018-2022), with deal volume declining 24% for the same period. As in past years, growth investments dominated the deal flow in the region, with Singapore and Indonesia remaining the primary contributors to the majority of deals. Deal activity declined in the first quarter of 2024. With a deal value of USD1.4 billion, South-East Asia's deal activity returned to the same level as in Q1 2023.

Singapore, however, took the lead in South-East Asia PE activity amidst the region's decline. In 2023, the city-state led a muted South-East Asian PE market, with investors carrying out fewer and smaller deals due to macroeconomic and geopolitical challenges. Singapore PE deal value fell by 50% from USD7.4 billion in 2022, while South-East Asia as a whole experienced a 35% decrease from USD13.7 billion. The number of deals in Singapore fell by 37% from 2022, and the entire South-East Asia region saw a 40% reduction from 2022.

Private credit

The ongoing expansion of private credit in Asia's debt financing landscape appears poised to persist. A report by EY highlights that while private credit is still nascent in South-East Asia, it has tremendous growth potential and opportunity for investors amid subdued deal and fundraising activity.

Asia's rapidly expanding private credit market is drawing an increasing number of participants, largely driven by the financing needs of small and medium-sized companies, which are increasingly turning to private credit for funding.

According to a report by finews.asia, private credit's growth in Asia's debt financing landscape shows no signs of slowing, with the recent entry of new players into the private credit space highlighting the growing recognition among borrowers of the benefits offered by private credit firms, including timely and tailored credit support.

Recently, in February 2024, global alternative asset management group Tikehau Capital and South-East Asia's largest brokerage, Singapore-based UOB-Kay Hian, announced the launch of a new private credit strategy, with each partner contributing USD50 million in capital.

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Singapore's central bank and financial regulatory authority, the Monetary Authority of Singapore (MAS), has also shared how it intends to commit to supporting private credit managers in their Asian expansion.

In a March 2023 speech by its Executive Director of Financial Markets Development, it addresses three key ways in which Singapore can support the private credit industry to overcome challenges:

- as a global Asia gateway, the Singapore financial sector can connect global markets and support Asia's development.
- Singapore has a trusted legal system that provides greater predictability and enhances enforceability to safeguard the interests of general and limited partners.
- Singapore is committed to supporting general partners' access to quality talent.

Back in 2022, the MAS pledged USD1 billion in investment to private credit funds, supporting fund managers expanding in Asia.

Given such government support for the private credit industry, an increase in the establishment of private credit funds in Singapore is expected in the near future.

Sustainability sector: transitioning to a low-carbon economy

The sustainability sector continues to ride a mega-trend, with the global shift towards a low-carbon and sustainable future necessitating a transformation among businesses in Singapore.

Companies must become more conscious of their carbon footprint and adapt to increasing investor and consumer demand for green products and services. They also need to implement decarbonisation and energy efficiency measures.

As businesses and governments alike prioritise ESG factors, PE firms are directing capital towards companies and technologies that promote sustainability.

These investments are not only aimed at generating financial returns but also at driving positive environmental impact. By backing innovative solutions in renewable energy, energy efficiency, waste management, and other green technologies, PE is playing a crucial role in accelerating the transition to a more sustainable economy.

PE firms are also increasingly investing in sustainability-themed asset managers, recognising the potential for strong returns and positive environmental impact. These investments are directed towards assets and management firms that focus on renewable energy, sustainable infrastructure, and other green technologies, aligning financial goals with the growing demand for sustainable and responsible investment practices.

For example, in January 2024, PE firm Stonepeak Partners LP invested an undisclosed stake in AGP Sustainable Real Assets, the Singapore-based global infrastructure and real assets developer and operator.

Active secondaries amidst a weak stock market

Amidst a generally lacklustre 2023 for South-East Asian stock markets, there has been greater PE secondary activity.

A report by Bain has highlighted how South-East Asia's PE industry needs stronger stock markets to facilitate exits through IPOs. While the weak exit environment is not exclusive to South-East

Asia, Bain's data revealed that exit conditions are a more serious issue for PE players in South-East Asia compared to other Asia-Pacific markets.

South-East Asian PE fund managers were primarily concerned by challenging exit conditions, whereas the difficult macroeconomic conditions in the broader Asia-Pacific region caused disquiet to APAC-focused managers.

Velocity, the ratio of traded value to market capitalisation, indicates the level of trading activity on an exchange. South-East Asian exchanges, including the Singapore Exchange, have relatively low velocity compared to some of their global peers. This could be a constraining factor if PE firms are looking to exit via an IPO in a South-East Asian exchange.

Robust stock markets play an important role for South-East Asia's PE funds because the majority of the region's PE deals are based on a growth strategy. This focus is expected given the region's fast-growing economies, which are bolstered by favourable demographics and growing consumption levels.

Growth-centric deals involve companies that are established but require additional funding to expand. This approach contrasts with early-stage investments in companies that may not yet be profitable, and buyouts that target mature companies.

As such, growth-centric strategies tend to favour exits via IPOs, and many of South-East Asia's PE managers invested with the expectation of exiting through an IPO. Given a lacklustre South-East Asia stock market, we are seeing secondaries becoming an increasingly popular choice for exits.

For example, PE giant Carlyle acquired a minority stake in Quest Global, the Singapore-based engineering company, with investors Bain Capital and Advent International exiting, in a deal valued at USD600 million. Additionally, Warburg Pincus acquired a 47% stake in Everise Holdings Pte Ltd, the Singapore-based provider of customer and product experience services, from Everstone Capital Asia Pte Ltd, in a deal valued at approximately USD342 million.

Healthcare and education are sectors in focus

The rise of the aspirational consumer is a powerful force driving demand across various sectors in South-East Asia. This burgeoning demographic is not only increasing its consumption of products and services but also seeking better quality healthcare, accessible financial services, and high-quality education.

The aspirational consumer market trend is driven by a growing middle class with rising incomes, greater access to information, and heightened expectations for their lifestyle and well-being. As these consumers pursue improved living standards, their spending patterns are reshaping markets and creating significant opportunities for businesses across the region.

Understanding and catering to the needs of the aspirational consumer will be crucial for companies looking to thrive in South-East Asia's dynamic and rapidly evolving marketplace.

Healthcare

According to data from Bain, 2023 marked a peak period in healthcare deal-making, making up 24% of South-East Asia's total deal value, thanks to several significant transactions in the provider sector. This surpassed the previous

peak in 2019, when healthcare deals accounted for 22% of the region's deal value.

Notably, Hong Kong PE firm Templewater has embarked on a string of acquisitions in Singapore, starting with its acquisition of OncoCare Medical, a private medical oncology clinic group in Singapore. This was followed by Novena Heart Centre, a multidisciplinary cardiology group in Singapore, and more recently, in May 2024, oncology centre Singapore Breast Surgery Center, and Can-Care, a retailer and distributor of post-cancer care products.

Additionally, a Japanese consortium comprising Mitsui & Co and Rohto Pharmaceutical acquired an 86% stake in Singapore-based traditional Chinese medicine company Eu Yang Sang International from Righteous Crane Holding, which is owned by a fund managed by Tower Capital Asia, as well as a unit of Temasek Holdings and founding family members of Eu Yan Sang.

Education

PE investment in Singapore's education sector is gaining momentum, driven by the city-state's reputation for high-quality education and its strategic position as a hub for educational excellence in Asia.

With a growing demand for premium education services, ranging from early childhood education to higher education and vocational training, PE firms are recognising significant opportunities for growth and returns.

Investments are being funnelled into innovative educational technologies, international school chains, and specialised training institutes, aiming to capitalise on the increasing appetite for diverse and robust educational offerings.

The sector's potential is further bolstered by supportive Singapore government policies and a strong emphasis on lifelong learning, making it an attractive target for PE players seeking to invest in the future of education in Singapore.

Some notable education sector deals in the past year include the acquisition by Apollo Global Management, a global alternative investment manager and PE firm, of an undisclosed stake in Global Schools Foundation, the Singapore-based education institution.

Technology – spotlight on AI and consequent demand for digital infrastructure

Singapore is widely recognised as a data centre hub. The city-state's strategic location, robust infrastructure, stable political environment, and supportive regulatory framework make it an attractive destination for data centre investments. Singapore's connectivity, both in terms of physical infrastructure and high-speed internet, coupled with its strong data protection laws, further enhances its appeal as a prime location for data centres.

Major tech companies and global data centre operators have established significant operations in Singapore, reinforcing its status as a key data centre hub in the Asia-Pacific region. With the rising demand for cloud computing and the commercialisation of AI expecting to place pressure on data storage resources, it is unsurprising to observe a significant increase in deals related to data centres in the city-state recently.

For example, in December 2023, India-based industrial conglomerate Reliance Industries Ltd completed its acquisition of 33.33% of Mercury Holdings SG Pte Ltd, a Singapore-based company engaged in building data centres, from Brookfield Corp, the Canada-based asset man-

agement firm focusing on real assets such as property, renewable power, infrastructure and private equity assets.

Additionally, in March 2024, a band of institutional PE investors, comprising the likes of Hillhouse Investment Management, Tekne Capital Management, Princeville Capital and Boyu Capital acquired a 43.9% stake in DigitalLand, a Singapore-based company managing international data centre assets, in a deal valued at USD587 million.

More recently, in June 2024, it was reported that a KKR-Singtel consortium will invest SGD1.75 billion in Singapore headquartered data-centre provider ST Telemedia Global Data Centres, in a deal said to be 2024's largest digital infrastructure investment so far in South-East Asia.

Tail-end of SPAC business combinations

In December 2023, Temasek-backed VTAC, the first SPAC that was listed on the SGX, successfully completed its business combination with Taiwanese live-streaming platform 17Live, cementing its status as Singapore's inaugural de-SPAC process, with a market capitalisation of approximately SGD886.9 million as at its first trading day on 8 December 2023.

The remaining two SPACs listed in Singapore have, on the other hand, announced plans to dissolve. With no current pipeline of SPACs being listed on the SGX, it is unlikely that the Singapore market will see more de-SPAC processes in the next twelve months.

Nonetheless, companies headquartered in Singapore have been the target of a few significant de-SPAC transactions in 2023 and 2024. These de-SPAC transactions have provided a capital markets exit for some PE investors, whilst others (including as sponsors and PIPE investors) continued to acquire significant stakes in SPAC targets as part of de-SPAC fundraisings.

In August 2023, APAC saw its largest deal completed thus far, with, Black Spade Acquisition Co's USD23 billion merger with VinFast, the Singapore-headquartered electric vehicle manufacturer.

Additionally in October 2023, Bridgetown Holdings, a SPAC backed by billionaire Peter Thiel, completed its merger with fintech player MoneyHero Group (dual-headquartered in Hong Kong and Singapore), valuing the combined company at an enterprise value of approximately USD310 million.

In November 2023, Fenix 360 Pte Ltd, a global social media company incorporated in Singapore and DUET Acquisition Corp, a SPAC incorporated in Delaware, announced that they have entered into a business combination agreement pursuant to which DUET Acquisition Corp will acquire 100% of the outstanding equity interests of Fenix 360 Pte Ltd, which is subject to regulatory approvals and other customary closing conditions, with the deal valuing Fenix 360 Pte Ltd at an enterprise value of USD610 million.

More recently in June 2024, Synagistics Pte. Ltd., a leading, Singapore-headquartered and data-driven digital commerce solutions platform in South-East Asia, and HK Acquisition Corporation, a SPAC listed on the Main Board of the Stock Exchange of Hong Kong Limited, announced that they have entered into a proposed de-SPAC transaction, valuing Synagistics at HKD3.5 billion (USD448 million).

However, given the relatively muted activity seen in the SPAC space on a global level, a slow-

down is expected in SPAC business combination activity with Singapore companies. According to data from statistica and Kroll, SPAC IPOs in the USA fell from 613 in 2021 to 86 in 2022, and to a mere 31 in 2023.

Conclusion

With optimism prevailing among deal-makers, there is a hopeful expectation of a revival in PE activity driven by anticipated rate cuts. Should this materialise, the trends and developments highlighted earlier are poised to play crucial roles, serving as essential tools and infrastructure that will bolster the market amid global challenges. As the market rebuilds and potentially reshapes itself, these factors are expected to remain pivotal in supporting a more robust PE landscape anticipated for the rest of 2024. Current anecdotal evidence suggests early signs of recovery in the second half of 2024, suggesting the potential for positive surprises in the year ahead.

SOUTH AFRICA

Law and Practice

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Bowmans delivers integrated legal services to clients throughout Africa and has nine offices in six countries. With over 500 lawyers, Bowmans' advice uniquely blends expertise in the law, knowledge of local markets and an understanding of clients' businesses. Clients include corporates, multinationals, funds and financial institutions as well as state-owned enterprises and governments. The firm's geographical footprint and independence places it in an excellent position to assist private equity funds with navigating the complexities of investing on the continent. The firm provides bespoke upstream and downstream services to the private equity sector in Africa. Members of the private equity team have advised on some of the largest private equity transactions undertaken in the region to date and have been involved in the formation of a number of Africa-focused private equity funds.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

Global inflationary pressures and a sluggish South African economy put pressure on deal activity in 2023 and this continued into early 2024 with added political uncertainty ahead of the national elections which took place in May 2024. However, the recent formation of a Government of National Unity has generally been viewed as a positive outcome which has been welcomed by the markets and it is hoped that this will trigger a resurgence in deal activity across the country.

1.2 Market Activity and Impact of Macro-Economic Factors

Opportunities remain in the infrastructure and energy sectors where there is a need for the private sector to fill the gap left as a result of the deterioration of public services and government infrastructure.

Restructuring transactions to avert business distress and unlock value have been prevalent in the South African market of late. Divesting of non-core assets to streamline operations and reduce debt burdens has increased.

There is also a programmatic approach to M&A with companies systematically and regularly engaging in M&A as a core part of their growth strategy. These entities are consistently pursuing a series of smaller to mid-sized acquisitions over time, instead of relying on occasional large, transformative deals.

Higher global interest rates together with a weaker local currency continue to place pressure on the South African private equity market (most notably in relation to those funds which are required to account to their investors in foreign currencies).

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Proposed Relaxation of Exchange Control Regulations

In an effort to encourage high-growth private equity funds to establish offshore entities from a domestic base, it is proposed that authorised dealers should be empowered to process requests by South African private equity funds that are licensed with the Financial Sector Conduct Authority (FSCA) to invest offshore up to ZAR5 billion per applicant company per calendar year in line with the outward foreign direct investment policy, without prior approval from the Financial Surveillance Department.

Companies Amendment Bills

The first and second Companies Amendment Bills of 2023 were passed by the National Council of Provinces (NCOP) in March 2024 and are currently awaiting assent by the President. The most contentious provisions pertain to the new remuneration disclosure requirements for both private and public companies. Highlighted amendments include: (i) public and state-owned companies should be starting to prepare for the structuring of binding remuneration policies, alignment of remuneration reporting and pay gap disclosures and new social and ethics committee requirements; (ii) private companies with ten or more direct or indirect shareholders that are contemplating an affected transaction should be readying themselves for the potential of additional regulatory scrutiny of their deals by the Takeover Regulation Panel; (iii) all companies should be giving thought to the alternative

dispute resolution mechanisms that they have agreed to in their corporate documents and whether or not these are still appropriate considering proposed amendments; and (iv) corporates should be cognisant that their annual financial statements and any disclosures included in their financials, director and officer remuneration or otherwise, will soon become public information.

The Conduct of Financial Institutions (COFI) Bill

The COFI Bill is an overarching regulatory framework that was meant to have been promulgated in 2023 but will now most likely be promulgated in 2024. The conduct requirements of financial institutions are currently regulated by a number of financial sector laws and guidelines. As part of the regulatory reform of South Africa's financial sector, the COFI Bill proposes to streamline the conduct requirements for financial institutions that are presently found in a number of different financial sector laws. In this regard, the COFI Bill will repeal some statutes in the financial regulatory space, while amending others.

Currently, private equity funds that are structured as limited liability partnerships are not regulated (as a product) and generally do not require registration in order to be promoted or offered in South Africa. Regulation of private equity funds is generally indirect through the regulation of the respective fund managers, who may be required to be licensed as financial services providers in terms of the Financial Advisory and Intermediary Services Act 37 of 2002, depending on their investment activities or roles.

When the COFI Bill is adopted into law, private equity funds will be regulated and licensable. The licensing obligation in relation to the offering of private equity funds will be placed on their managers.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

The Primary Regulators and Regulatory Issues Relevant to Private Equity Funds

In South Africa, the legal structure of private equity funds can take various forms, the most common being that of limited liability partnerships (known as *en commandite* partnerships). *En commandite* partnerships are a popular structure because they are relatively flexible, they are not (currently) directly regulated under law, and the contractual agreements utilised by the partnership remain private.

The Financial Advisory and Intermediary Services Act, No 37 of 2002 (FAIS)

Fund managers are required to have the requisite financial advisory licence pursuant to FAIS.

Regulation 28 of the Pension Funds Act, 1956

To the extent that a pension fund is invested into a private equity fund, the private equity fund will need to comply with additional reporting obligations in order to enable the investing pension fund to comply with its obligations under the Pension Funds Act.

The Collective Investment Schemes Control Act, 2002 (CISCA)

CISCA regulates collective investment schemes, prescribes ongoing obligations for such schemes and places the same under the regulatory oversight of the Financial Sector Conduct Authority (FSCA). CISCA does not formally regulate private equity structures as there is no formal private equity dispensation provided for in the CISCA framework. However, a private equity fund may constitute a "collective investment scheme" depending on how it pools its funds.

The COFI Bill

See **2.1 Impact of Legal Developments on Funds and Transactions** in relation to the COFI Bill.

Primary Regulators and Regulatory Issues Relevant to Private Equity Transactions

Private M&A activity is mainly regulated in terms of the Companies Act 71 of 2008 (the "Companies Act"), under which a number of transactions require the consideration of the Takeover Regulation Panel subject to the takeover regulations issued in terms of the Companies Act.

Listed M&A deals are regulated by the Companies Act as well as the Johannesburg Stock Exchange (JSE) through the JSE Listings Requirements.

Foreign investments or any form of externalisation of funds by South Africa resident investors are generally subject to exchange control regulations prescribed by the South African Reserve Bank (SARB), and any such transactions will require the authorisation of the Financial Surveillance Department of the SARB.

Competition law authorities established under the Competition Act 89 of 1998 have significant powers in respect of M&A activity and are responsible for investigating, approving or prohibiting mergers. Proposed mergers that are above the prescribed thresholds are subject to mandatory merger notifications prior to the implementation of such mergers.

The competition law authorities consider both competition law and public interest factors in determining whether a proposed transaction is capable of justification. Competition and public interest factors carry equal weight in the analysis conducted by the competition authorities. The competition analysis determines whether a merger substantially prevents or lessens competition, whilst the public interest analysis considers the impact of a proposed transaction on certain specified public interest grounds. Amongst these public interest grounds are the effect that a proposed transaction will have on the promotion of a greater spread of ownership by historically disadvantaged South Africans and workers in firms in the market, as well as on employment. The former has seen an increase in conditional merger approvals, with the establishment of employee share ownership schemes being a prominent theme. Preventing merger-specific job losses continues to remain an imperative of the competition authorities.

Depending on the sector in which the target operates, additional regulatory approvals may be required.

Sovereign Wealth Investors

There is no distinction in the way that national security (or other) regulators assess financial investors depending on whether or not they are sovereign wealth investors.

EU FSR Regime Relevant for Transactions in South Africa

The new EU FSR regime has not had a material impact on South African private equity funds.

Anti-bribery, Sanctions and ESG Compliance

Draft amendments to the Money Laundering and Terrorist Financing Control Regulations have been published for public comment. The amendments include provisions related to reporting thresholds (international cash transactions exceeding ZAR25,000 must be reported to the Financial Intelligence Centre (FIC)), required information for cash or negotiable instruments conveyance reports, and designation of author-

ised recipients of such reports. Failure to declare transactions may potentially result in criminal conviction or hefty fines. These amendments aim to bolster protocols against money-laundering, enhance the FIC's ability to detect suspicious transactions, and facilitate South Africa's removal from the grey list.

One of the key recommendations of the Zondo Commission of Enquiry into State Capture was the introduction of an offence related to the failure to report corruption. This recommendation has now been implemented via the introduction of Section 34A of the Prevention and Combatting of Corrupt Activities Act. In terms of the new Section 34A, a member of the private sector or any state-owned entity will be guilty of an offence if a person associated with that company or state-owned entity offers or gives a prohibited gratification to obtain or retain business or an advantage in the conduct of business for that company or state-owned entity.

In addition to the legislative changes set out above, these topics are increasingly relevant in M&A transactions. There is also increased sensitivity around sanctions and/or possible sanctions, given the stance adopted by the South African government towards Russia and the conflict in the Ukraine.

4. Due Diligence

4.1 General Information

Red flag, or "exceptions only", legal due diligence is the most common form of due diligence in South Africa. In unilateral transactions, due diligence is run by the purchaser, whereas auction processes typically involve a vendor due diligence which is then supplemented by purchaser top-up due diligence. Black box and clean team arrangements are common for transactions involving trade buyers.

Apart from business-specific issues, due diligence is also typically conducted in relation to restrictions on transfer and general regulatory compliance (including environmental, data protection and anti-bribery and corruption laws).

4.2 Vendor Due Diligence

Vendor due diligence is common for private equity sellers in the context of auction processes. These will ordinarily be red flag, or "exceptions only", vendor due diligence reports. In auction sales it would be typical for sell-side advisers to provide bidders with an initial "teaser" document. Bidders that sign up to a non-disclosure agreement are then provided with a more detailed information memorandum, and bidders that have provided attractive non-binding offers are then provided with vendor due diligence reports (which typically cover legal, financial and tax but can also include environmental vendor due diligence, depending on the nature of the target asset).

Buyers typically conduct top-up and/or confirmatory due diligence in relation to vendor due diligence reports or legal fact books and are granted access to the virtual data room for this purpose.

Reliance on vendor due diligence reports by the successful buyers is common.

5. Structure of Transactions

5.1 Structure of the Acquisition

Most private equity deals are typically concluded via private treaty sale and purchase agreements. The terms of the transaction do not differ materi-

ally between privately negotiated deals and auction sales, save to note that in auction sales the transaction agreements are usually more favourable to the seller (depending on the extent of competition involved in the auction process).

5.2 Structure of the Buyer

In most instances, the private equity fund will incorporate a ring-fenced acquisition vehicle and it is less common for the private equity fund itself to be the direct buyer of the asset. Typically, the fund manager is heavily involved in the negotiation of the buy- and sell-side transaction agreements.

5.3 Funding Structure of Private Equity Transactions

Depending on the size of the transaction, private equity deals are typically funded through a combination of senior third-party debt and funds committed by the private equity fund. Given a number of factors, including: (i) higher interest rates affecting cost of debt; and (ii) local elections in South Africa, there has been lower deal flow in the South African market in the last 12 months.

Established and well-known private equity houses are rarely asked to provide equity commitment letters from their investors but, depending on the nature and size of the transaction, these are sometimes used in order to provide contractual certainty. Similarly, it is not common to require certain debt funds at signing from such private equity houses. Where comfort is required (for the reasons mentioned in relation to equity commitment letters) debt commitment letters from the lender are sometimes used. In other instances, advisers to the fund are asked to confirm that the drawdown arrangements in the fund agreements are binding and that there are sufficient undrawn commitments available to fund the equity portion of the purchase price.

Whether a transaction is for a majority or minority stake will be entirely dependent on the acquisition strategy and investment mandate of the relevant private equity fund.

5.4 Multiple Investors

Consortiums are relatively common, especially in larger transactions where the private equity fund requires additional investors in order to obtain the desired stake in the target company or where the private equity fund does not have sufficient remaining commitments from its existing investors.

The composition of the consortium will depend on the nature of the transaction. Whilst corporate investors do sometimes participate in consortiums, this is less common than participation by existing investors and/or other private equity funds. Where the consortium comprises a private equity fund and one or more of its existing investors, then existing investors are often willing to accept a passive stake. Third-party co-investors will typically require a degree of positive or negative control depending on the size of their stake.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Consideration Structure

Most transactions are priced either using a locked-box or completion accounts mechanism. Fixed-price transactions are not common, as there is generally a prolonged period between the signing of the documents and the closing of a transaction due to various regulatory approvals

being required, with the associated need for an adjustment mechanism.

Deferred Consideration

Earn-out arrangements and deferred consideration are fairly common in South African M&A transactions. Rollover structures are less common but are sometimes implemented where members of the management team are sellers.

Transactions involving a private equity seller often result in some form of deferred consideration in order to avoid formal escrow arrangements and allow purchasers to set off any warranty or indemnity claims against the deferred consideration. Although the authors note that set-off of warranty and indemnity claims will also be dependent on whether or not warranty and indemnity insurance has been obtained in relation to the transaction.

Private equity sellers are typically hesitant to provide any form of security against downward adjustments to the purchase price or leakage payments beyond the typical contractual obligations contained in the transaction agreements. However, most deals are structured on the basis that only a downward price adjustment is anticipated.

Private equity buyers are able to provide security to sellers through confirmation of their total commitments over and above the initial purchase price.

6.2 Locked-Box Consideration Structures

Interest is commonly charged on the purchase price. In addition, (reverse) interest will generally be charged on leakage at the same rate that interest is charged on the purchase price so that the purchaser will be placed in the position they would have been in had the leakage not occurred.

6.3 Dispute Resolution for Consideration Structures

It is common for both locked-box and competition accounts pricing mechanisms to have bespoke dispute resolution mechanisms. Parties will generally prefer an expert (for example, a corporate finance house or independent auditor) to consider disputes relating to the pricing aspects of a transaction rather than for same to be regulated in terms of the general dispute resolution mechanism. Expert determination mechanisms are generally used for consideration structures as they provide clear-cut guidelines on how an expert will be invited by the parties to address any differences they may have in respect of the determination of the purchase price.

Prior to appointing an expert, parties will often try to address the dispute between themselves and only refer the particular matters they may have failed to reach agreement on for the expert's determination.

6.4 Conditionality in Acquisition Documentation

In addition to the mandatory regulatory conditions – including exchange control approvals, takeover regulation approvals, antitrust approvals and other industry-specific regulations which may be applicable to a particular transaction – private equity transactions are often also subject to other conditions, such as the procurement of acquisition finance, third-party consents as well as shareholder approvals and waiver of pre-emptive and other analogous rights (although both sellers and buyers will typically seek to limit the number of conditions in any transaction).

Whilst material adverse change/effect clauses were not previously common in South Africa, there has been a significant increase in the use of material adverse change/effect provisions in transactions since 2020, as parties seek to bridge the uncertainty that was created by the COVID-19 pandemic as well as other aspects beyond a party's control that may impact a transaction or a target business.

6.5 "Hell or High Water" Undertakings

It is not common for private equity buyers to accept "hell or high water" undertakings in relation to regulatory conditions in the transaction documents (whether in respect of merger control and/or foreign investment regulatory conditions).

Whilst the concerns are less pronounced in relation to foreign investment regulatory conditions, in so far as merger controls are concerned, the competition authorities are required to assess mergers with reference to both competition and public interest effects and the Competition Act makes provision for the Minister of Trade, Industry and Competition (the "Minister") to intervene and make representations in merger proceedings on specific matters of public interest. The public interest assessment includes:

- whether a merger is likely to impact employment;
- its effect on local industrial sectors;
- the ability of small and medium-sized enterprises, or firms owned and controlled by historically disadvantaged persons (HDPs), to participate within the market;
- the competitiveness of national industries in global markets; and/or
- the spread of ownership, and in particular, ownership in a firm by HDPs or workers.

The broad public interest criteria empowers the competition authorities to impose a range of conditions, which has had a significant effect on a number of mergers involving foreign acquiring firms. Private equity buyers are therefore often unwilling to accept "hell or high water" undertakings given the uncertainty regarding the extent or nature of the conditions which may be imposed by regulatory authorities.

There has been limited engagement, in the context of South African deals, with the EU FSR regime.

6.6 Break Fees

In general, break fees are not common in private equity transactions which don't involve listed entities. However, it is not uncommon to see a break fee in favour of the buyer in a preliminary term sheet (any such break fee often falls away in the formal transaction agreements).

Break fees are more common in public M&A deals and where the target is subject to the Takeover Regulations. Even though the amount and terms of a break fee are decided by contractual negotiation between the parties, the Takeover Regulation Panel has published a guideline advising that it will allow for payment of a break fee not exceeding 1% of the offer. Therefore, transactions which require approval from the Takeover Regulation Panel will need to comply with the above-mentioned guideline.

6.7 Termination Rights in Acquisition Documentation

As noted in **6.4 Conditionality in Acquisition Documentation**, South Africa has recently seen the increased use of material adverse change provisions which allow a buyer to terminate an agreement prior to completion. These provisions typically only allow for termination based on an

actual material adverse change to the target's business (termination of the agreement is typically not a remedy in relation to material adverse changes in the market or general economic conditions). Outside of a material adverse change provision, termination is usually limited to termination pre-completion of the transaction for a material breach of the transaction agreement which is either incapable of remedy or is not remedied within a certain period of time.

A typical longstop date would depend on the nature and extent of the conditions and the complexity of the transaction. Where regulatory approvals are required (especially merger controls), the longstop date will typically occur between four and six months after the date on which the transaction documents are signed.

6.8 Allocation of Risk

Risk allocation is always heavily negotiated and is dependent on the nature of the business, the level of due diligence, the composition of the seller(s) and pricing. As such, risk allocation is largely transaction specific.

Sellers are typically protected through a combination of limitations on their liability. These primarily include (i) financial limitations (overall liability caps, basket thresholds and minimum claim thresholds), and (ii) time limitations for the institution of warranty and indemnity claims.

6.9 Warranty and Indemnity Protection

Warranties Provided by Private Equity Sellers

Private equity sellers in South Africa are typically open to providing warranties on exit. However, this depends on their percentage stake in the target company, and their involvement in the day-to-day operations of the target company. Generally, their appetite is decreasing in the context of the growing warranty and indemnity insurance market in South Africa. To elaborate, a private equity seller which held a passive and/or minority stake may refuse to provide operational warranties. These warranties are typically limited both from a financial and timing perspective (as detailed in **6.8 Allocation of Risk**).

Warranties Provided by the Management Team

A management team will typically provide warranties (including operational warranties) where the management team is exiting alongside the private equity seller. A standalone management warranty deed or agreement is uncommon, although being used more frequently in the context of warranty and indemnity insurance. Where the management team is reinvesting into the target alongside the buyer and/or will continue to operate the business post-closing of the transaction, the buyer will always be reluctant to claim from its management team and will often give management assurances in this respect.

Management liability is subject to the same limitations as applied to all warranty claims and will typically be proportionate to their equity stake (usually a minority stake).

Disclosure of the Data Room

Whether a buyer is willing to accept the full disclosure of the data room will usually depend on the extent of the due diligence undertaken by the buyer and the contents and organisation of the data room. Disclosure is usually subject to the concept of "fair disclosure".

Typical Limitations of Liability

Limitations of liability are the subject of negotiation and are somewhat transaction specific. Generally, however, the following ranges of limitations on liability are seen in private equity deals:

- de minimis of between 0.1% and 1% (although generally on the lower end of the spectrum);
- a tipping basket between 1% and 2.5%;
- the aggregate cap on claims differentiates between different categories of warranties, where typically:
  - (a) fundamental warranties will be capped at 100% of the purchase price; and
  - (b) business warranties will be capped at between 10% and 30% of the purchase price (although there may be specific categories of business warranties which have a separate, higher cap – eg, anti-bribery and anti-corruption, environmental or tax warranties); and
- the time period for bringing claims in respect of business warranties ranges between 18 and 36 months, while the time period for bringing claims in respect of fundamental warranties and tax warranties ranges between five and seven years.

6.10 Other Protections in Acquisition Documentation

Specific indemnities are limited to specific risks identified during the due diligence exercises as well as in respect of any taxation payable by the target business prior to the implementation of the transaction.

Warranty and indemnity insurance has gained traction in the South African market and is attractive to private equity sellers in terms of allowing for a clean exit. Such insurance can also cover tax matters (subject to certain exclusions – eg, transfer pricing). However, the authors' experience is that insurers are becoming more exhaustive in their underwriting processes, which has resulted in an increased number of exclusions from the warranty and indemnity (W&I) cover and increased costs associated with insured deals. As a result, this has limited the growth of W&I insurance as an effective tool for private equity sellers. That being said, there has been an increase in the use of W&I in the South African market in the last 12 months. The authors also note that insurers in the South African and African markets have indicated a greater appetite for more extensive cover for these jurisdictions, which may be driving the increase.

Whilst escrow provisions are quite common in private M&A transactions, they are rarely used in private equity transactions.

6.11 Commonly Litigated Provisions

Formal court litigation is not common due to the lengthy court processes in South Africa. It is quite standard for transaction agreements to contain provisions in terms of which the parties submit to arbitration to resolve any disputes arising in respect of the transaction agreements. Arbitration proceedings are most common in relation to W&I claims.

Disputes in relation to consideration mechanics and earn-outs are typically determined by experts in terms of the specific expert determination processes set out in the transaction agreements.

7. Takeovers

7.1 Public-to-Private

There has been an increase in the number of delistings from the JSE in recent years, and an increase in delistings of small cap stocks is anticipated going forward.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

In terms of Section 122 of the Companies Act, a person must notify a "regulated company" within three business days following that person's acquisition of a beneficial interest in sufficient securities of a class issued by that company, such that, as a result of the acquisition, the person holds a beneficial interest in securities amounting to 5%, 10%, 15%, or any further whole multiple of 5%, of the issued securities of that class.

7.3 Mandatory Offer Thresholds

South Africa has a mandatory offer threshold of 35%. If a person, acting alone or in concert with other persons ("concert parties"), has acquired a beneficial interest in any voting securities issued by a "regulated company" and the concert parties are now, as a result of the acquisition, able to exercise more than 35% of the voting rights attaching to the securities of that company, the concert parties must make a mandatory offer to acquire all the shares of the other shareholders of the company.

According to Section 123 of the Companies Act, if a person acting alone has, or two or more related or interrelated persons acting in concert have, acquired a beneficial interest in voting rights attached to shares of a regulated company, and before that acquisition such persons jointly were not able to exercise more than 35% of all the voting rights attached to the securities of that company but, as a result of the acquisition, now exercise more than 35% of all the voting rights attached to the securities, the persons in whom more than 35% of the voting rights attached to the securities of the company now vest must give notice to the holders of the remaining shares within one business day of the acquisition. This notice must include a statement: (i) that they are in a position to exercise at least the prescribed percentage of all the voting rights attached to securities of that regulated company; and (ii) offering to acquire any remaining securities in accordance with the Companies Act and the Takeover Regulations.

7.4 Consideration

Cash transactions are most commonly used as consideration. Share-for-share transactions are typically limited to internal group restructurings.

7.5 Conditions in Takeovers

Common conditions include the procurement of regulatory approvals including competition law approval, Takeover Regulation Panel approval, exchange control approval and other industry-specific approvals, as well as any other approvals that may be required from the shareholders.

Conditions that are in the control of or dependent on the subjective judgment of an offeror or the directors are not allowed, and conditions must be objectively determinable. An offer conditional on the bidder obtaining financing is not permitted as the offer circular, which must be issued by the board of directors to the shareholders following receipt of the offer, must contain a written statement that an unconditional and irrevocable guarantee has been issued by a South African-registered bank or that a third party has confirmed that sufficient cash is held in escrow in favour of the shareholders to meet any payment obligations of a bidder arising from the offer.

Parties can agree to break fees, match rights, exclusivity arrangements and non-solicitation provisions, and such provisions are not uncommon. The breach of exclusivity arrangements, for instance, may lead to break fee payments in favour of the offeror, subject to a maximum cap

of 1% of the offer as prescribed by the Takeover Regulation Panel. There are no caps applicable to reverse break fees, but these are not common in the South African context.

7.6 Acquiring Less Than 100%

A majority acquisition would typically provide a buyer with the ability to control the board. Minority shareholders can seek additional protections through board representation and reserved matters.

The Companies Act sets the threshold for special resolutions at 75% and ordinary resolutions at more than 50%. However, the memorandum of incorporation of a company may amend these thresholds, provided that there is always a 10% margin between ordinary and special resolutions.

To squeeze out minorities requires a general offer coupled with a squeeze-out. An offeror can make a general offer to shareholders of a company to acquire their shares. Each shareholder is free to accept or reject the offer, but if the offer is accepted by the holders of at least 90% of all the issued shares (other than those held by the offeror), the holders of the remaining shares can be compelled to sell their shares, pursuant to the "squeeze-out" provisions in Section 124 of the Companies Act.

7.7 Irrevocable Commitments

It is common for an offeror to seek and obtain irrevocable commitments to tender or vote by principal shareholders of the target company. The Takeover Regulation Panel has published guidance to the effect that an offeror may approach five or fewer shareholders, each of whom holds 5% or more of the target's issued shares, subject to confidentiality requirements and compliance with insider trading rules. A Takeover Regulation Panel dispensation may be sought to approach the top five shareholders who hold less than 5%, or to approach more than five shareholders.

Negotiations are typically undertaken no more than two to four business days prior to the announcement of an offer. This is because key shareholders are precluded from trading shares in the target company whilst they have inside information regarding a potential offer.

Key shareholders may provide irrevocable undertakings to accept a tender offer or to vote in favour of a scheme; the undertakings may be more or less qualified ("hard" or "soft"). Alternatively, they may provide letters of support for an offer, rather than an irrevocable undertaking. The undertakings sometimes provide an out if a better offer is made. The announcement of an offer must contain details of any irrevocable undertakings obtained from key shareholders in respect of the offer.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentivisation of the management team is common practice, and it occurs either through direct equity incentives or notional equity arrangements.

The management stake will vary from deal to deal, but it is usually a small minority stake (5%–15%), often with a ratchet up to a higher percentage if targets are met on exit by the private equity shareholder.

8.2 Management Participation

Sweet equity is relatively common in South Africa, especially in the context of start-ups and private companies. In private equity funds,

investors may structure deals where they offer sweet equity to key management personnel or founders as part of the investment terms. This can help ensure that those leading the company are motivated to achieve successful outcomes.

Where management cannot fund their participation, the target or the private equity shareholder will often fund their participation through vendor finance arrangements. In this regard, dividends declared to the management shares will be used to settle the purchase price for the management shares. In such instances, management may not enjoy the full economic benefit of their shares until such time as the purchase price has been settled in full. Use of preferred instruments is not uncommon, particularly in instances where management's participation has been funded by persons other than management. Such instruments may not have rights to dividends and other rights until the purchase price for the management shares is settled.

Preferred instruments are also common in ratchet incentives.

In South Africa, preferred instruments in such arrangements can take various forms, including preferred shares, convertible instruments and/or preferred participation rights.

8.3 Vesting/Leaver Provisions

Vesting Provisions

Vesting provisions are sometimes seen, particularly where management's stake is subject to a ratchet mechanism. In this context, vesting usually refers to the entitlement date of the respective awards.

Leaver Provisions

Most leaver provisions provide for a deemed offer of management's shares to the company or other shareholders upon the occurrence of specific events. These events would include leaving the employ of the company on good terms (also referred to as "good leaver events"), leaving the employ of the company on problematic terms (also referred to as "bad leaver events"), breaching certain key agreements and various insolvency triggers. The price for such deemed offer shares may, subject to tax aspects (as discussed below), be subject to a discount in certain instances (particularly for bad leaver events).

Management's shares are also often subject to a specific lock-in period. After that period, management can then fully enjoy the economic benefits of their shareholding (subject to having repaid any vendor financing).

In addition, there might be a restriction on who the shares can be transferred to, be it to another management team member or someone who is not deemed a competitor of the company.

Tax – Section 8C

In determining a taxpayer's income, Section 8C of the Income Tax Act, 58 of 1962 takes into consideration any gains or losses made upon the vesting of an equity instrument acquired pursuant to that taxpayer's employment with a company or them holding the office of a director of that company.

In practice, Section 8C applies more commonly to restricted equity instruments; ie, equity instruments that cannot be freely disposed of by the taxpayer (often the management shareholders) at market value and/or equity instruments, ownership of which can be forfeited at a consideration which is below the market value (as defined) if the taxpayer (also management) fails to remain in the employ of the company for a specific period. When such instruments vest, the excess of

the market value of such shares as at the date on which they vest over the purchase price of such shares may be taxable as income and subject to employees' tax. In instances where management did not pay for such shares, the entire market value for the shares may be taxable.

Section 8C therefore plays an important role when considering management's tax consequences while balancing leaver triggers, values and other provisions.

8.4 Restrictions on Manager Shareholders

It is common practice for management shareholders to agree to non-compete and non-solicitation covenants and restrictions; however, whilst parties generally reach agreement on these matters easily, developments in South African labour and related laws have over the years made it difficult to enforce these provisions.

Such covenants must therefore always be balanced against (i) a manager's constitutional right to freedom of trade, occupation and profession; and (ii) public policy considerations and public interest.

The law unfortunately does not prescribe the specific public policy considerations that must be taken into account, nor does it define what constitutes public interests. Nevertheless, in negotiating for non-compete and non-solicitation covenants, the covenants must not be so wide as to impede on one's right to freedom of trade, occupation and profession, and the covenants must prescribe a specific territory within which the restrained manager may not operate, industrial practices the manager may not undertake and a reasonable period during which the covenants will be effective.

Certain of these restrictions would ordinarily be contained in the equity package, whilst others will be in the employment contract.

8.5 Minority Protection for Manager Shareholders

Minority protection for manager shareholders (where the private equity fund holds the majority stake) is always transaction specific, but it is common for management shareholders to enjoy veto rights in respect of key issues, such as the procurement of debt above certain levels, amendments to the structure of an entity, amendments to the nature of the target business and amendments to key constitutional documents. This will generally be applicable where the management shares have been fully paid for.

Anti-dilution protections for management who hold a minority stake are not common but can be negotiated in the context of specific concerns (eg, dilution in terms of shareholder funding).

Private equity funds will generally structure transactions with their exit in mind and relevant governing documents will cater for this. In that regard, there will be very limited, if any, management influence over, or restriction on the exit of the private equity fund. At best, management will have tag-along rights to sell their stake alongside the private equity fund, whilst the private equity fund will have a drag-along right to force management to sell their shares if necessary. It is not uncommon for the private equity fund to have a call option to acquire management shares at an agreed price prior to their exit. In any event, management typically undertakes to support an exit whether they retain their stake or sell alongside the private equity fund.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

If a Private Equity Fund Holds a Majority Stake

Where a private equity fund holds a majority stake, control will be exercised through board appointment rights (and subcommittees, where relevant) which will effectively entitle the fund to control the board. Additional protections may be provided through shareholder approval requirements (also referred to as reserved matters), most notably in relation to issues where directors nominated by the private equity shareholder may be conflicted in terms of their fiduciary duties to the company.

By virtue of its board representation (coupled with confirmation that said directors can disclose such information to its nominating shareholder), it would get access to various information and insight into the portfolio company.

If a Private Equity Fund Holds a Minority Stake

Private equity fund shareholders generally negotiate for control rights (in the form of either reserved matters at an appropriate threshold which would include them in the vote, or in terms of a specific veto vote) in respect of key company decisions (typically including limiting borrowings, key personal changes, acquisitions/disposals of material aspects and related-party transactions). These key decisions also sometimes include deciding on company budgets, strategy and business plans. However, this always has to be balanced against competition law considerations as same could be construed as an acquisition of control of the relevant company which may create the need for antitrust filings and approvals.

Board appointment rights (and subcommittees, where relevant) are also common. However, voting would generally be linked to shareholding of the nominating shareholder (as opposed to one vote per director) so would not necessarily afford control.

Information rights would be solidified in the shareholders' agreement to ensure that, in addition to information that they are entitled to in law, any specific reports, information or documents are provided on request or at agreed intervals. This will be driven by the private equity fund's reporting obligations to its investors, which may include specific ESG or other information and timelines.

9.2 Shareholder Liability

The South African Companies Act 71 of 2008 does provide for the piercing of the corporate veil and enables courts to lift the protection afforded to directors and shareholders by virtue of a company being a separate juristic personality.

Case law generally prescribes that the corporate veil may be pierced where there is proof of dishonesty, fraud or improper conduct in respect of a company's affairs, such that it may be appropriate to consider any such conduct as that of a director or shareholder and not necessarily of the company, even though it has a separate legal persona.

10. Exits

10.1 Types of Exit

Management teams are increasingly looking to take up a bigger stake when their private equity-backed investors exit.

The typical holding period in South Africa is usually three to seven years, but this has been extended from seven to ten in more recent years (primarily as a result of COVID-19).

Most exits are still conducted by way of secondary buyouts to other private equity firms or private sale to other companies. Dual- and triple-track exits are not common in South Africa, but do occur on occasion.

While the expectation of investors in private equity funds are still that they would, at the end of the term, share in the returns of realising all underlying investments, continuation funds are gaining popularity in Africa and Southern Africa. This option allows the investor to maximise their investment if the time is not right to exit, but roll-over or re-invest in the continuation fund while still holding onto a specific investment.

10.2 Drag and Tag Rights

Drag and tag rights in South Africa are quite typical.

The ability to drag other shareholders can often have a minimum internal rate of return or times money back requirement attaching to it, or can be afforded to a majority private equity shareholder in light of its exit requirements, and private equity shareholders often negotiate for drag-along rights in private equity transactions. However, it is not common to see drag-along rights enforced without co-operation from the other shareholder(s).

A drag threshold will usually be 50%.

Tag-along rights do not typically have a threshold in the same way as drag-along rights; they are often given to specific minority investors.

Management teams may have specific obligations or undertakings to reinvest in the company alongside the new purchasers, even if they have tag-along rights.

Institutional co-investors may also negotiate different thresholds or conditions for drag and tag rights depending on their level of involvement and the terms of their investment and control.

10.3 IPO

There is no mandatory lock-up period, and lock-up periods are negotiable (if applicable in the context). A lock-up period would, however, generally be shorter for a private equity fund investor than the management team who may hold shares.

Where a shareholder holds a substantial shareholding in a listed entity, it is not unusual for such a shareholder to conclude a relationship agreement with the company in terms of which such shareholder may get preferential treatment, including the ability to nominate persons for appointment to the board of directors, and there may be an agreement on how the shareholder can dispose of its shares.

Private equity fund shareholders also usually get a preferential exit right on IPOs. Furthermore, it is important to manage the valuation and timing of an IPO during the process.

Trends and Developments

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Bowmans

Bowmans delivers integrated legal services to clients throughout Africa and has nine offices in six countries. With over 500 lawyers, Bowmans' advice uniquely blends expertise in the law, knowledge of local markets and an understanding of clients' businesses. Clients include corporates, multinationals, funds and financial institutions as well as state-owned enterprises and governments. The firm's geographical footprint and independence places it in an excellent position to assist private equity funds with navigating the complexities of investing on the continent. The firm provides bespoke upstream and downstream services to the private equity sector in Africa. Members of the private equity team have advised on some of the largest private equity transactions undertaken in the region to date and have been involved in the formation of a number of Africa-focused private equity funds.

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Introduction

South Africa's private equity (PE) environment has, in the last year, been gaining momentum and attracting diverse investors seeking opportunities. PE funds form an important source of finance for businesses in developing and emerging economic markets, especially startups and small-to-medium-sized firms (SMEs). Particularly for businesses with significant development potential, PE funding has assisted in bridging the funding gap that traditional banks and financial institutions have been unable to provide. The growth in interest from both local and international investors in the PE space in South Africa has led to an increase in deal activity and investment opportunities across various sectors.

Impact Investing

Over the past few years, issues around climate change and social disruptions have increased, leading to the growing awareness that the traditional ways of conducting business are no longer sustainable. The universal recognition is that all market participants, including private equity firms, must adopt the values and corporate strategies which focus on Environmental, Social, and Governance (ESG) factors, both in their investment objectives and throughout the life cycle of their investments.

Impact investing involves deploying capital with the intention of generating positive, measurable social or environmental impact alongside financial returns. This approach requires projects and businesses to contribute to sustainable development goals, addressing issues such as climate change, poverty, and inequality. Investors are increasingly looking to generate both financial returns and positive social or environmental impact through their investments.

This trend is particularly relevant in South Africa, where issues such as poverty, inequality, and unemployment remain significant challenges within South African society. Impact investing in sectors such as education, healthcare, food and affordable housing has the potential to drive sustainable development and create long-term value for both investors and society.

Renewable Energy

The energy investment sector remains popular in South Africa as a result of the country's ongoing battle against energy shortages that have seen the state-owned Electrical Supply Commission (Eskom) implement load shedding.

PE firms are continuing to invest in independent power producers (IPPs) which produce renewable energy (RE) and sell to Eskom, which in turn supplies electricity inside South Africa. According to Eskom's Medium-Term System Adequacy Outlook 2024–2028, without significant recovery in Eskom's energy availability factor, South Africa will continue to experience high levels of unserved energy demand, and thus load shedding, until at least 2028.

According to the National Energy 2024 Market Intelligence Report, the lifting of licensing requirements for large-scale generation projects and efforts to address the electricity crisis have all played a role in the growth of South Africa's RE market.

Since the opening of power generation to competition and the first round of public procurement of renewable power projects in 2011, RE capacity has expanded rapidly resulting in numerous opportunities for investment within this sector in South Africa.

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Technology

The Information and Communications Technology (ICT) sector is key to driving digital transformation in South Africa, which has one of the largest ICT markets in Africa. There has been a notable rise in investment in the technology sector, most likely as a result of South Africa's efficient ICT products and services industry.

Subsidiaries of international companies based in South Africa as well as South African-based companies have, in recent years, supplied most of the new fixed and wireless telecoms networks established across the African continent. There are increasing opportunities becoming available within South African organisations looking for assistance in utilising efficiencies from cloud computing such as Software-as-a-Service and Infrastructure-as-a-Service. Cloud computing is becoming more important in South African organisations due to improved bandwidth availability, security, and lowered cost of broadband, as well as additional internet providers competing in the market. PE opportunities in the ICT sector have increased as a result of these recent technological advancements and increase in demand within South Africa and the rest of the African continent.

Notably, advanced technology is seen as an efficient method of reducing margin erosion. PE firms are increasingly encouraged to use technological tools such as artificial intelligence and social media to their advantage and move away from the traditional (and often costly) methods of deal sourcing. Employing technology in the PE environment will effectively enhance the manner in which information is analysed.

Financial Technology (Fintech)

South Africa has become a leader in African financial innovation with its fintech sector rapidly growing and attracting significant investment. Payment solutions in South Africa have continued to dominate financial technology innovation and attract substantial investments from PE firms.

The financial technology sector in South Africa has been boosted by its young and tech-savvy population. In addition to this, South Africa's relatively low costs and large market offer in the tech ecosystem provides for a number of investment opportunities by PE firms. It is a market with lower volatility and promising investment opportunities in companies with strong management and affordable talent.

Broad-Based Black Economic Empowerment

An important development in the South African PE market is the rise in the number of black-owned and managed companies. It is reported that more than half of the PE firms in South Africa are owned by persons from historically disadvantaged backgrounds. Initiatives aimed at encouraging Broad-Based Black Economic Empowerment (B-BBEE) have been essential in fostering diversity and inclusivity within the economy, providing previously marginalised entrepreneurs with access to cash and knowledge.

The purpose of the South African government's B-BBEE policy is to bridge the economic gap created by apartheid and to promote transformative financial inclusion by granting incentives for employing black people in managerial positions. This includes, inter alia, the opportunity for entities to conduct business with the South African government or Organs of State.

The Code of Good Practice measures a company's B-BBEE scoring and assigns B-BBEE levels dependent on the number of black mem-

bers occupying specific positions within the business, with level 1 being the highest score and level 8 being the lowest.

Foreign investors are adapting their approaches to conform to B-BBEE and the expectations of the South African Competition Commission by incorporating employee share ownership schemes into their investment deals in South Africa. This is also a good way to keep the management of the acquiring organisation in place, which in some cases is likely to increase the stability and future worth of the organisation. Employee share incentive schemes implemented with the objective of recognising black ownership and promoting valuable employee commitment are a recognisable trend in the PE market.

These initiatives to improve B-BBEE participation must be considered as companies with a relatively low scoring may hinder their opportunities to effectively participate in sustainable investing. It is increasingly becoming more evident that the PE firms that participate in the enhancement of socio-economic practices benefits, and promote diversity and inclusion, will invariably yield a strong return in investment.

Agriculture and Agro-Processing

Opportunities for PE firms to invest in agriculture and agro-processing, together with the impact of technology in this sector, have seen the industry come to the fore as a profitable investment sector in South Africa.

Primary agriculture contributes to around 2.5% of South Africa's gross domestic product, with the sector's overall contribution, including the value chain, showing a substantially higher contribution of 10.3% at the end of 2023.

The prominent role of the agricultural sector stems from the purchase of fertilisers, chemicals and implements by farmers, as well as the export of primary products, distribution into the food chain, and the supply of raw materials for agro-processing. The agricultural value chain is thus an important growth engine for the rest of the South African economy. The primary production and agro-processing industries are labour intensive, which is important for job creation and promoting the growth of small and medium enterprises in South Africa.

While PE investors tend to avoid investing in the production of agricultural commodities, it rings true that technology and big data is positively impacting the agricultural sector and the opportunities it provides. In light of climate change and water shortages, the agricultural sector is at an advantage in implementing new technology that can efficiently determine water levels, irrigation methods and salinity levels, to ensure there is an optimum environment for agricultural growth and ultimately yield a valuable investment return for investors.

PE investors are undoubtedly beginning to seek opportunities which yield a high return with the option of active management participation in the portfolio companies they have invested in.

Natural Resources

South Africa continues to have abundant and diverse natural resources, which present significant opportunities for PE investors. The country is rich in minerals such as gold, platinum, diamonds, and coal, making it a global leader in mining.

The abundance of natural resources not only fuels the mining and agricultural sectors, but recent studies have shown how these sectors

support related industries such as manufacturing, logistics, and export trade in South Africa.

As a result, these resources continue to contribute to South Africa's economic resilience and attractiveness as an investment destination for PE investors, promising long-term opportunities for growth and development in a resource-rich environment.

Cross-Border Deals and Collaborations

Evidence has shown an increase of M&A activity with foreign entities investing in South African assets. An important development in the PE industry in South Africa is the growing interest from global investors, especially those from the US and Europe. These investors are drawn to South Africa because of its youthful population, diverse economy, and unexplored market potential.

Consequently, there has been an increase in cross-border deals and collaborations between domestic and international PE companies, creating a more dynamic and competitive investment environment.

Larger PE funds are now concentrating on pan-African investment prospects, especially in data and energy hubs, after previously just concentrating on South Africa. Nonetheless, many PE funds with their headquarters in other parts of Africa are still actively looking for investment opportunities in South Africa. This indicates that South Africa is still a desirable place for PE investors to do transactions given its generally stable economy in the African continent and point of entry into other African markets.

Regulatory

South Africa continues to boast a well-established entrepreneurial ecosystem with a strong pool of talent and supportive regulatory environment, which is attractive for PE investors.

Notably, the effects of the recent amendments to Regulation 28 of the Pension Funds Act on pension fund allocations to PE investment firms made possible a bigger and distinct allocation of 15%, a welcome rise from 10%, to PE investments.

In the same breath, political unpredictability and regulatory uncertainty are two key challenges for PE investors in South Africa. However, after tense elections, the country peacefully formed a Government of National Unity (GNU), creating a sense of hope even though there may be some changes as markets observe how well the GNU is implemented.

Job Creation

South Africa has witnessed a rise in ambitious younger individuals taking on leadership roles in organisations. Alongside this is the rise of online and digital young entrepreneurs. In recent years, PE investee companies grew employment by 4.2%, whilst the wider South African economy grew employment by 2%.

Youth unemployment in particular is a prevailing issue in the South African economy. In an attempt to alleviate this, the South African National Treasury has provided an incentive to companies that can be used to reduce overhead costs and potentially improve the South African economy and society at large by employing youth.

Opportunities

Although South Africa's PE environment offers investors and entrepreneurs a myriad of interesting opportunities, these are not without their challenges. The global rise in inflation and scar-

city of local finance sources are the main challenges, particularly for early-stage start-ups and SMEs. As a result, there is now a dependence by these entities on foreign funding, which is unpredictable and vulnerable to external economic circumstances.

A major risk to the expansion of the PE industry has also been the crippling effects of rolling electricity cuts and deterioration of public services and infrastructure. South Africa also continues to struggle with problems with the staffing, maintenance, and upkeep of important port and rail infrastructure. However, the country is experiencing the longest continuous period without load shedding since 2020, and this has sparked predictions of additional growth. Substantial progress has also been achieved in addressing economic challenges through the intentional drive on government-private sector collaboration.

PE-backed platforms may also facilitate effective government-private collaborations. Additionally, there are great opportunities for PE investors to provide the risk capital that South African businesses need to weather any current economic downturns and position themselves for rapid and durable expansion.

Conclusion

In conclusion, PE firms are expected to play a significant role in the M&A rebound in South Africa. The PE landscape in South Africa is continuing to evolve rapidly, driven by changing global and market dynamics, technological advancements, and shifting investor preferences. Investors currently wanting to invest in South Africa will certainly not be left without any challenges to overcome. However, South Africa's optimism surrounding its new government and renewed political landscape, diverse high-growth sectors, ambitious workforce, and rich natural resources are just some of the key areas providing great opportunities for PE investments in South Africa.

SOUTH KOREA

Law and Practice

Contributed by:
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Lee & Ko is Korea's premier full-service law firm, and its private equity team is held in the highest regard for its ability to handle complex transactions for both domestic and overseas private equity funds. Since the introduction of regulations governing private equity funds in the early 2000s, its private equity team has been a pioneer in the field, having successfully advised on the formation of the first private equity fund in Korea. With the growth of the private equity market in Korea, the firm's private equity team has grown into one of the largest and most trusted practices in the country. In recent years, it has garnered cutting-edge transaction experience and knowledge, having represented global and domestic private equity firms in some of the most high-profile M&A transactions in Korea.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

Joint investments between private equity funds and strategic investors are on the rise. This trend stems from the amendment to the Financial Investment Services and Capital Markets Act (FISCMA) in 2015 allowing for:

- the incorporation of multi-level special-purpose companies for investment purposes; and
- investment by strategic investors into special-purpose companies.

As joint investments with strategic investors came to the fore, funds that had previously focused on buyout transactions also recently began to invest as minority financial investors.

As private equity funds invest in start-ups like venture capital, and venture capital invests in large-scale like private equity, there is a blurring of the boundaries between private equity and venture capital in the M&A market in Korea.

1.2 Market Activity and Impact of Macro-Economic Factors

Due to recent struggles with inflation and the resulting rise in interest rates, we have seen a sharp decline in liquidity that was overflowing in the market until 2021. In this way, there has been a slowdown of fund formation and M&A activity involving funds, generally. Despite that, there has been a modest uptick in these activities over the course of the past twelve months, with liquidity largely coming by way of equity commitments as leverage continues to be hampered by high interest rates.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

The FISCMA was amended on 20 April 2021 and the amendment took effect on 21 October 2021. Under the amended FISCMA, private funds are categorised as “general private funds” or “institutional private funds” and private equity funds under the previous law transitioned to institutional private funds. Both types of private funds are allowed to invest freely, but the scope of investors for institutional private funds are limited to qualifying institutional investors, including financial companies and listed companies meeting certain requirements, and the offering procedure for general private funds, which are open to individual and general investors, have become more rigorous.

As investors that can take part in institutional private funds are limited to financial companies, listed companies meeting certain requirements and other institutional investors, market entry of newly formed general partners that do not have ready access to these investors have become more impenetrable.

For the purposes of this article, references to private equity funds are generally to private funds that are categorised as “institutional private funds”.

In June 2023, the Venture Investment Promotion Act was amended to allow for the establishment of special-purpose companies that can borrow funds using the resources of venture capital (defined as “venture investment associations” under the Venture Investment Promotion Act). This amendment is expected to diversify venture capital investment structures and further stimulate venture investments.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Primary Regulators

The primary regulators relevant to private equity funds and transactions involving these funds are the Financial Services Commission and the Financial Supervisory Service as funds established under the FISCMA bear a duty to continuously report matters ex post to the Financial Services Commission and/or the Financial Supervisory Service from the time of incorporation/establishment to the time of liquidation, in accordance with the applicable laws. The subject of these reports consists not only of the fund's total commitment and contribution amounts, but also the identities of the target companies in which the funds made investments.

On the antitrust regulatory front, as the legal entity form of funds established under the FISCMA is typically a company, the establishment of these funds will in most cases require approval of business combination from the Korea Fair Trade Commission (KFTC). That said, on 29 June 2023 a Cabinet meeting at the Presidential office approved the amendment of the Monopoly Regulation and Fair Trade Act (MRFTA) pursuant to which the formation of private equity funds will no longer be subject to the business combination report. It was passed by the National Assembly on 6 February 2024, and the amended Act will come into effect on 7 August 2024.

According to the amended MRFTA, if a company required to file a business combination report jointly participates with another company in the establishment of a private equity fund under the FISCMA and becomes the largest investor, such participation will be excluded from the business combination report requirement. Consequently, starting from 7 August 2024, business combination reports for the establishment of private equity funds will no longer be required.

However, this exemption only applies to the establishment of new private equity funds, and the business combination report will be required in the following cases:

- a private equity fund invests in a target company; or
- a new limited partner invests in an already established private equity fund or an existing limited partner makes an additional investment or acquires the interest of another limited partner.

However, in the case of a new limited partner investing in an already established private equity fund or an existing limited partner making an additional investment or acquiring the interest of another limited partner, a simplified review process will apply, making the procedure less burdensome than a private equity fund investing in a target company.

When private equity funds established overseas seek to offer equity to Korean investors, they must undergo a registration process with the Financial Services Commission and the Financial Supervisory Service in advance.

In terms of anti-bribery, sanctions or environmental, social and governance (ESG) issues, there is a growing trend among overseas funds to conduct separate due diligence on the target's compliance issues before consummating the transaction. To the extent any shortcoming is found in the course of the diligence, the common approach is to introduce new policies or demand enhancement of the existing policies of the target.

Regulatory Issues

There are three main regulatory issues that impact transactions involving private equity funds.

First, if the target is a listed company, private equity funds, like other market participants, have disclosure obligations on various matters to the Financial Services Commission, the Financial Supervisory Service and/or the Korea Exchange (KRX). Additionally, although this rarely occurs in Korea, if a private equity fund intends to invest by way of a tender offer, it must proceed in compliance with the procedures prescribed by the FISCMA. One of these requirements is to provide evidence of funds sufficient to satisfy accepted offers prior to the commencement of the tender offer. This, in practice, is burdensome for private equity funds due to the nature of the timeline of their capital calls (ie, within a certain period leading up to closing). In the recent Osstem Implant transaction, a landmark tender offer deal in South Korea, Lee & Ko provided evidence of funds to regulators in the form of letters of commitment (which led to the regulators later revising the relevant regulations to expressly allow this form of evidence). In this way, investments by way of tender offer have become a considerable option for private equity funds.

Second, when acquiring more than a certain equity stake in a target that is above a certain size, a private equity fund must obtain approval on business combination from the KFTC. While this regulation also applies to other market participants, in the case of private equity funds, the anti-competitiveness is determined based on the entirety of the fund's portfolio companies.

The last regulatory issue only applies to overseas funds. These funds bear an obligation to report on the acquisition of target shares to the Korea Trade-Investment Promotion Agency, foreign exchange banks and/or the Bank of Korea under the Foreign Exchange Transaction Act or the Foreign Investment Promotion Act. Furthermore, these overseas funds may be restricted from investing, or limited in their shareholding ratio, in certain industries in which foreign investments are statutorily barred or regulated, such as broadcasting or telecommunication.

In addition, if the target possesses National Core Technology as designated under the Act on Prevention of Divulgence and Protection of Industrial Technology, the overseas fund must obtain prior approval from, or file a report in advance with, the Minister of Trade, Industry and Energy in order to acquire over a certain percentage of the target's shares.

4. Due Diligence

4.1 General Information

In the course of M&A in Korea, it is standard practice to conduct full-blown due diligence, unless the target is very small. Information is usually provided through a virtual data room and management presentations/break-out sessions, as well as periodic requests for information (RFIs) and written Q&As, among other platforms. While the depth of review differs on a case-by-case basis, the legal due diligence is generally conducted without a materiality threshold.

For private equity investors, the focus of legal due diligence does not stray significantly from that of a corporate buyer and due diligence is conducted in all areas including corporate/securities, equity ownership/dilution, material contracts, licences/permits, employment/labour and litigation, etc. However, in the case of private equity investors, it is more common to perform

separate due diligence on compliance matters (anti-bribery and corruption/AML/sanctions) or ESG issues.

4.2 Vendor Due Diligence

Although vendor due diligence is generally not a common feature, in comparison to transactions involving a typical corporate seller, transactions involving private equity sellers are more likely to feature vendor due diligence or fact-books, particularly in the context of an auction sale. While there may be instances where advisers attach a liability cap to the vendor due diligence reports upon providing credence thereto, the status quo is non-reliance. This also applies to buy-side diligence reports.

5. Structure of Transactions

5.1 Structure of the Acquisition

Most private equity funds are acquired through private treaty sale and purchase agreements. Although auction sales are often held for larger-scale M&A, privately negotiated transactions are more common across the board. Tender offers, on the other hand, are rarely carried out in Korea. However, from 2023 there have been several high-profile tender offers involving private equity buyers such as MBK and Unison Capital Korea (UCK) Partners' tender offer of Osstem Implant, IMM PE's tender offer of Hanssem, and Hahn & Company's tender offer of Lutronic.

There are no notable differences between the terms of a privately negotiated transaction and the terms of an auction sale. However, it is often the case in auction sales that seller-friendly terms (eg, material adverse effect (MAE) bring-down, warranty and indemnity (W&I) insurance) are agreed upon from a closing certainty or seller's clean exit perspective.

5.2 Structure of the Buyer

In Korea, although private equity funds sometimes become party to the transaction, it is more often the case that a special-purpose company that the fund incorporated for such purpose (investment purpose company, or IPC) becomes involved in the acquisition documentation. In order to limit liability exposure, funds are expected to maintain the current deal practice of utilising IPCs for acquisition documentation purposes. Inbound investments by overseas funds are also structured in the same way by utilising IPCs.

5.3 Funding Structure of Private Equity Transactions

Financing of Private Equity Deals

For private equity funds under the FISCMA, the deals are normally financed by contributions from the investors of the fund. For funds that apply a leverage strategy, the IPC may additionally secure financing, but under the current FISCMA, the leverage ratio thereof is restricted at 400%. As there is judicial precedent holding that providing assets of the target as security for the acquisition financing of the IPC may be deemed to be a breach of fiduciary duty of the target's directors, acquisition financing is not secured by the target's assets under Korean law. Acquisition financing is instead secured by the assets of the borrower, the IPC, such as the target shares that the IPC is to acquire through the deal.

Equity Commitment Letters

Private equity funds that are blind funds in possession of considerable assets under management or dry powder are not often required to furnish equity or debt commitment letters. Apart from such instances – particularly if project funds or other debt financing sources are employed – equity or debt commitment letters are more likely to be requested from these blind

funds. Furthermore, in the Korean M&A market, a contract deposit representing 5% to 10% of the purchase price is commonly requested by the sell-side, in which case private equity buyers often satisfy this requirement by furnishing equity or debt commitment letters.

For overseas funds, equity commitment letters and debt commitment letters are provided in most instances.

Typical Private Equity Deals

In the past, private equity funds favoured control deals (eg, buyouts), but minority-stake investments have become more frequent as of late. In particular, large-scale private equity funds and overseas funds have been very active in conducting pre-IPO investments and other minority investments.

5.4 Multiple Investors

In buyout investments, it is uncommon for a consortium of private equity sponsors to collectively enter into a transaction, while in minority investments, it is more common to find a consortium of private equity funds to make a joint investment.

In Korea, direct and/or indirect co-investment by strategic/corporate investors who seek to acquire control over the target in the future and to make financial gain, alongside private equity funds is commonplace. Under the FISCMA, investment by such strategic investors in the IPC is also permitted.

The articles of incorporation of private equity funds under the FISCMA often include provisions on granting priority rights to the limited partners to make joint investments with the fund, when it is difficult for these funds to unilaterally make investments given the size of the investment opportunity, and large institutional investors (eg, the National Pension Service) actively take advantage of these joint investment opportunities.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Fixed prices with or without a locked-box structure and completion accounts are all used as mechanisms for consideration in M&A transactions but the predominant form is fixed price without a locked-box mechanism. In cross-border deals, completion accounts are also in wide use but the domestic M&A market is also seeing more deals with completion accounts as well.

Rollover structures are common in transactions involving individual founders of the target who hold considerable equity stakes (eg, the largest shareholder) where their shares in the target, along with management and control rights, are transferred to private equity funds. Following this, the founders acquire a minority stake in the fund's capital (eg, 20% to 30% of sale proceeds).

While there are deals involving earn-outs, it is not a common feature of private equity transactions. For example, an earn-out is rarely used where a private equity fund is the seller, since such funds (especially funds incorporated for the purpose of investing in a single target investment company) are focused on completing distribution and liquidation shortly thereafter. Apart from this, there are no notable differences between private equity funds and corporate investors or sellers in determining the consideration mechanism and level of protection in relation thereto.

6.2 Locked-Box Consideration Structures

As mentioned in **6.1 Types of Consideration Mechanisms**, locked-box consideration structures are not commonly used in private equity transactions but, when used, there have been both instances of interest charged on leakage and not charged on leakage. Reverse interest on leakage is not common.

6.3 Dispute Resolution for Consideration Structures

Dispute resolution mechanisms featuring a dedicated expert are commonly found in locked-box or completion accounts consideration structure and typically the parties to private equity transactions are obliged to adhere to the decision of these dedicated experts. It is common for a designated independent accounting firm to act as the dedicated expert on disputes for locked-box and completion accounts consideration structures. Consideration structures which take into account the outcome of certain contingent events or investigations (eg, environmental studies of real property) may involve a dedicated expert of the relevant field (eg, environmental consultants).

6.4 Conditionality in Acquisition Documentation

The typical level of conditionality in private equity transactions is mainly as follows and does not differ from general M&A transactions:

- representations and warranties of the parties shall be true and correct (in all material respects). Furthermore, it is not uncommon for transactions involving private equity sellers to stipulate a material adverse effect to bring down the standard for business representations and warranties;
- parties shall have performed (in all material respects) the covenants required to be performed prior to closing;
- mandatory and suspensory regulatory conditions; in particular, business combination approval by the KFTC;
- no litigation prohibiting the consummation of the transaction; and
- in the case of a standalone no MAE provision, the condition becomes a key point of negotiation.

Limiting conditions to regulatory conditions is not typical and financing conditions are rarely found in acquisition documentation. Third-party consent conditions are included on a case-by-case basis, but infrequently and in the case of a change of control provision in contracts with key customers, the deal may be conditional upon procuring the relevant consents. Termination of these contracts may otherwise be deemed to be an MAE. Shareholder approval is included as a condition (only) when legally mandated (eg, transfer of all or a material part of a business).

6.5 “Hell or High Water” Undertakings

It is not common for a private equity-backed buyer to accept a “hell or high water” undertaking in deals with a regulatory condition. However, it is sometimes accepted in the bidding process by a fund investor that has no specific competing business in its portfolio to gain an advantage over the other bidders. There is often a distinction between merger-control and foreign investment conditions where, unless the underlying target’s assets comprise of national core technology resulting in greater foreign investment scrutiny, the “hell or high water” undertaking typically relates to matters of merger-control.

6.6 Break Fees

In private equity deals, break fees or reverse break fees are not ordinarily used. If break fees are prescribed in the acquisition documentation, however, reverse break fees are generally also prescribed therein.

When prescribing break fees, the Korean Civil Code estimates the fees to be the liquidated damages and if the court finds that the amount is excessive in comparison to the actual damages, the fees can be reduced. Therefore, most documentation deems the break fee to be a monetary penalty because although the Korean Supreme Court has held that even in the case of a monetary penalty, the courts can partially invalidate the amount, the monetary penalty must be "in contravention of public order and standards of public decency" to qualify for the reduction.

The triggers and volume of break fees varies greatly from one deal to another, but a common trigger in deals involving private equity funds is when a party fails to consummate closing despite all closing conditions having been satisfied.

6.7 Termination Rights in Acquisition Documentation

Apart from termination by mutual agreement, the typical circumstances of termination in private equity transactions are mainly as follows and do not differ from those of general M&A:

- either party (materially) breached the representations and warranties or did not perform (in material respects) the covenants prior to closing and failed to cure this within a certain period; and
- if the closing has not occurred on, or prior to, the long-stop date, which is typically between three to six months following signing (in a deal with antitrust concerns, nine to twelve months).

6.8 Allocation of Risk

In transactions where a private equity fund is the seller, and, in particular, where the fund was solely established to invest in the target company, the seller's interest lies in prompt distribution and liquidation, and, as such, it typically rejects any additional allocation of risk post-closing (ie, clean exit). Previously, funds achieved this purpose by bearing liability and providing an escrow for breach of representations and warranties on a short-term basis. More recently, it has become common practice for private equity sellers to limit their liability by demanding the buyer to subscribe to W&I insurance and only bearing liability in the case of fraud.

In transactions where a private equity fund is the buyer, there are no notable differences with transactions involving general corporate buyers.

6.9 Warranty and Indemnity Protection

As explained in **6.8 Allocation of Risk**, private equity sellers normally provide general warranties in the same manner as corporate sellers but attempt to limit liability by requiring the buyer to subscribe to W&I insurance.

For the same reasons as provided in **8.1 Equity Incentivisation and Ownership**, it is not customary for the management team to hold shares, but where a management team is selling shares it holds, it normally provides the same level of warranties to the buyer as the private equity seller.

To limit liability for warranties, survival periods, de minimis, basket and cap are all utilised in documentation and anti-sandbagging is generally a fiercely negotiated point. Survival periods for mid to large-size deals that proceed via

auction bids are typically one and a half to two years, with longer periods usually granted for specific warranties on tax, labour, environment and compliance. Regarding quantum limitations, the amounts can vary from deal to deal but caps rarely go beyond 10%. Finally, on limitation on liability for known issues, while full disclosure of the data room as an exception to the warranties was not commonly accepted in the past, recently there has been an uptick in sellers who make such demands in conjunction with anti-sandbagging.

6.10 Other Protections in Acquisition Documentation

As examined above in **6.8 Allocation of Risk**, private equity sellers previously sought protections by bearing liability for breach of representations and warranties on a short-term basis and having an escrow in place to back these obligations. However, recently, private equity sellers have more often taken protection by making the buyer subscribe to W&I insurance and only bearing liability in the case of fraud. W&I insurance has become commonplace in deals with private equity sellers in the past several years.

However, where the seller is an overseas fund, the buyer must withhold capital gains tax but because the calculation of the withholding amount is based on the information provided by the seller, if tax is later collected from the buyer, the seller must indemnify the buyer thereon. Although insurance companies now offer products that cover liabilities stemming from capital gains tax, the risk is most commonly covered by a guarantee or an escrow for credit reinforcement provided by the overseas fund or its parent.

When prescribing to W&I insurance, the coverage often extends to both fundamental and general business warranties including tax warranties (for unknown risks), albeit the claims period for fundamental warranties would typically be for a longer duration. From time to time the buyer may be inclined to acquire a standalone tax cover to insure any potential liability (which is a known risk) resulting from the seller's capital gains tax obligations (as discussed above), particularly if the seller is a foreign entity.

In the case of escrow or holdback amounts, there is typically no distinction between recourse for fundamental or general business warranties.

6.11 Commonly Litigated Provisions

Litigation in connection with private equity transactions is not common, but occurs from time to time. The most commonly litigated provisions are those on indemnification pursuant to breaches of representations and warranties, but disputes also occur in connection with shareholders' agreements where a private equity fund is the minority investor (eg, disputes over put options following failure to conduct an IPO).

7. Takeovers

7.1 Public-to-Private

Up until the first half of 2023, public-to-privates in private equity transactions had been uncommon. In the case of the Osstem Implant take-private transaction, which is currently in the process of delisting, the buy-side consortium comprised of MBK Partners and UCK Partners had undergone two tranches of tender offers in order to meet the minimum shareholding threshold for delisting. Market observers believe that a key component for success in this landmark transaction was that the tender offer price was equal across the board and all participants benefited from the management premium.

In a public-to-private transaction, the involvement of the target and its board of directors is limited until the tender offer is completed. That said, the company plays a key role in holding meetings with shareholders and the board of directors during the delisting phase of the transaction. Relationship agreements between the buyer and the target are uncommon in Korea.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

In the case of listed companies, the FISCMA stipulates that holders of 5% or more of the shares in listed companies must disclose various matters, including the quantity and class of shares, security provision status, unit prices at the time of acquisition and disposition, and counterparties in the acquisition and disposition transactions. The 5% is calculated by aggregating the shares held by a shareholder and its specially related parties (including affiliates and joint holders). On the other hand, shareholders of an unlisted company do not bear these obligations.

Shareholders of listed companies holding 10% or more on an individual basis must disclose their shareholding status. Holders of 5% or more shares must report on the change to shareholding where there is a change of 1% or greater to the shareholder's shareholding ratio. Holders of 10% or more shares must report on the change to the number of shares held where the change is in relation to 1,000 shares or more.

In order to make a tender offer including private equity-backed bidders, one must first publicly disclose the tender offer and file a tender offer statement and a prospectus thereof, which includes the following:

- matters concerning the tender offeror and related persons;
- the issuer of the securities subject to the tender offer;
- the purpose of the tender offer;
- the class and number of the securities subject to the tender offer;
- the terms and conditions of the tender offer, including the period, price, and payment date of the tender offer;
- the provisions of a contract for purchase (or other transaction) of the securities without the tender offer after the public notice date of the tender offer, if such a contract exists; and
- the details of the purchasing fund and other matters prescribed by Presidential Decree as necessary for the protection of investors.

7.3 Mandatory Offer Thresholds

The FISCMA stipulates a mandatory offer to be triggered where a buyer and its affiliate(s) hold 5% or more of the shares issued by the target by purchasing shares from 10 or more persons within a six-month period. In this case, even if the transactions were not made at a stock exchange, they are deemed over-the-counter unless they were made via blind auction.

The Financial Services Commission announced new revisions to the FISCMA during 2023, including a mandatory threshold for tender offers to secure more than 50% plus one share when proposing to acquire 25% or more of the shares of the target issuer. Private equity funds in Korea are closely monitoring this development.

7.4 Consideration

In most cases, the consideration is cash. No minimum price rules apply to tender offers.

7.5 Conditions in Takeovers

Until 2022, listed company transactions were rarely conducted via a tender offer. Most Korean listed companies have a controlling shareholder

and M&A transactions on such listed companies are conducted by purchasing shares over-the-counter from the controlling shareholder. Until recently, there have been rare exceptions of the buyer making a tender offer on the remaining shares following the above-mentioned transaction and going private. Over-the-counter transactions with a controlling shareholder include the same conditions as a general private M&A and, as such, financing is rarely included as a condition and the offer conditions cannot include those beyond the limited conditions allowed under the law (eg, certain portion of the shares to be tendered).

From the first half of 2023, there have been several takeovers by private equity backed buyers of listed companies by tender offer. A financing condition is not legally permitted since the tender offer statement must be accompanied by a document substantiating the balance of deposits in financial institutions or any funds pooled, equivalent to or more than the amount required for the tender offer.

7.6 Acquiring Less Than 100%

Even if a bidder does not obtain 100% ownership of a target, if it obtains sufficient shares to affirmatively resolve shareholder resolutions, the bidder can acquire control through director appointments. Upon obtaining controlling shares from the controlling shareholder of a listed company and subsequently obtaining 95% or more shares via a tender offer, the buyer can apply for voluntary delisting. In this case, the purchaser must provide another opportunity to the remaining shareholders on settlement trading following the delisting.

On a related note, under Korean law, a controlling shareholder holding 95% or more shares may cash out the 5% shareholders by undergoing a certain procedure, which is not highly utilised in practice, but this process can be used in obtaining 5% or less shares following the voluntary delisting.

There are no particular mechanisms for a private equity-backed bidder to achieve a debt push-down into the target following a successful offer. That said, it should be noted that Korean courts have ruled that putting up the target's assets for collateral relative to the debt of the parent (eg, acquisition financing) is considered a breach of fiduciary duty of the target's board of directors. On a similar note, Korean courts have also found that merging the target following a successful offer with a highly leveraged parent may be considered a violation of these fiduciary obligations.

7.7 Irrevocable Commitments

As discussed in previous responses, obtaining the shares of a listed company via a tender offer is rare in Korea.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Incentivisation of the management team is a common feature of private equity transactions and the incentive can take the form of both cash and equity. Equity incentivisation by equity-linked compensation is commonly found in private equity transactions.

In general, equity ownership is not common for the management team and even if there is such ownership, the ratio is very low. However, it is common for a private equity fund to:

- purchase most of the equity from the founder of an unlisted company with the founder,

holding some of the remaining equity, caused to continue to manage the company; or
- cause the founder/seller of an unlisted company to reinvest in the fund with a lower priority in dividend compared to those of other investors while continuing to manage the company.

8.2 Management Participation
For the reasons raised in **8.1 Equity Incentivisation and Ownership**, it is rare for managers to hold equity. Even if there is equity ownership, it is generally not structured as sweet equity or institutional strip. Equity tends to be granted to management by the grant of stock options or cash incentives that are linked to performance and/or future exit considerations of the private equity buyer.

8.3 Vesting/Leaver Provisions
For the reasons provided in **8.1 Equity Incentivisation and Ownership**, there are no typical leaver or vesting provisions. In the case of stock options, there is a statutory requirement of being in service for at least two years and generally the exercise period is determined to begin two to three years from the grant date until the fifth year therefrom. In the case of equity–linked compensation such as restricted stock units (RSUs), it often takes the structure of vesting over the course of around five years depending on the performance of the company or the individual.

8.4 Restrictions on Manager Shareholders
It is customary to agree to restrictive covenants on non-compete and non-solicit undertakings during the term of employment and for a certain period following resignation. However, there is no clear standard on the length of this period under Korean law.

As the non-compete undertaking can raise an issue concerning infringement of the constitutional right to profession, the risk of invalidation of this undertaking can be minimised where the consideration corresponding to the non-compete undertaking can be proved and the undertaking is not in place for an excessive duration. Although this undertaking is determined on a case-by-case basis, it is understood that the validity thereof is likely recognised for six months to one year and the validity of any period exceeding one year may not be so readily recognised. Such undertakings are often stipulated in employment contracts.

8.5 Minority Protection for Manager Shareholders
For the reasons provided in **8.1 Equity Incentivisation and Ownership**, manager shareholders generally do not enjoy any protection other than tag rights nor carry any substantive influence over the exit or control of the private equity fund. However, depending on the equity ratio and importance in company business of the manager shareholders, matters of protection or influence can be settled differently. If the manager shareholder holds a high equity ratio and is key to the company business, rights akin to a minority shareholder's rights in a joint venture could be negotiated for the manager shareholder, including anti-dilution protections.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights
Private equity fund shareholders with majority shares tend to exercise de facto control over the portfolio companies by appointing directors.

On the other hand, where a fund invests as a minority shareholder, it is typical for the fund to enter into a shareholders' agreement with the controlling shareholder and obtain the right to appoint at least one person to the board of directors, veto rights over major management matters and information rights.

With respect to the veto rights, while they vary on a case-by-case basis, funds tend to demand veto rights over change to capital or governance structure or transactions concerning assets, capital expenditure or loans, or related-party transactions, over a certain monetary threshold. However, if the largest shareholder seeks to consolidate its accounts with those of the target company, the consultation on veto rights tends to centre on pure minority protection rights, excluding matters on business plans, budgets, the appointment of representative directors and other ordinary business activities (as veto rights on such operational matters granted to the fund could be seen as stripping control of the largest shareholder, thereby undercutting its efforts to consolidate accounts with the target company).

9.2 Shareholder Liability

The Korean Supreme Court interprets the circumstances where the corporate veil may be pierced very narrowly and where the portfolio company is operated in compliance with the general procedural requirements of corporate governance, the courts are very hesitant to do so.

In one case, the court held that it is natural for overlaps to exist between the personnel of a parent company and those of its subsidiaries. The mere fact that the executive management team of the parent company holds similar positions in its subsidiaries, or that the parent company exercises control by virtue of owning all of the issued shares of its subsidiaries (or even that the subsidiaries' businesses and operations have expanded without their capital being increased) are not sufficient reasons to view such relationships as abuse of separate legal personalities (ie, corporate veil) in relation to obligations owed by subsidiaries to creditors. Something more fundamental is required for such abuse to be seen, like the total absence of a subsidiary's independent existence or will to operate whereby its operations are essentially run by the parent company one and the same as part of the parent company's own business.

In particular, it must be objectively apparent that the business and assets of the parent company and those of its subsidiaries, including as to external commercial transactions, cannot be distinguished or clearly separated. In addition, there must be a subjective element present, namely an intention to avoid the application of law to the parent company or the intention to abuse the corporate veil by utilising the subsidiaries as a purely credit-proofing measure in dealing with creditors.

10. Exits

10.1 Types of Exit

Until several years ago, (while there were no explicit regulations), the Korea Exchange (KRX) did not allow the listing of companies in which the largest shareholder was a private equity fund and, accordingly, the exit strategy of private equity funds was limited to a private sale. However, today, the KRX allows IPOs of these companies and IPO precedents are building, with a growing number of funds targeting an IPO as their key exit strategy. This is most applicable to investments to obtain control of the target because for minority investments in a target

expected to conduct an IPO in the near future, the exit strategy becomes more complex, with:

- partial sales of shares pre-IPO;
- sale during the IPO; and
- sale of the remaining shares in a post-IPO block deal.

Although infrequent in practice, there are instances where a partial exit is accommodated through recapitalisation prior to the final sale and/or IPO of the target. Subject to individual circumstances of the target and the relevant private equity funds involved, it is often the case that the most preferred exit strategy will be employed, whether that be in the form of a private sale, IPO or recapitalisation, and it is uncommon to concurrently pursue a dual or triple track exit.

Reinvestment upon Exit

Generally, private equity sellers, incorporated under Korean law, do not reinvest upon exit.

10.2 Drag and Tag Rights

It is not typical for a private equity fund holding a controlling stake of 50% or greater to also hold drag rights against the minority shareholders for its exit. However, where the existing largest shareholder or management remains as a minority shareholder, there are instances of the fund seeking drag rights and, in turn, the minority shareholders seeking tag rights. On a separate note, in an M&A transaction involving a consortium between private equity and a strategic investor, the private equity fund often seeks drag rights that can force the strategic investor to sell its shares at the time of the fund's sale of its shares carrying management rights.

Conversely, where the fund makes a minority investment, it often seeks drag rights against the controlling shareholder in preparation of any potential failures to exit via an IPO or other primary exit mechanisms (eg, failed put option).

In the scenarios presented in **8.1 Equity Incentivisation and Ownership** where the founder remains as a controlling shareholder, or where the private equity fund makes a minority investment, it is typical practice for the minority shareholder to hold tag rights in the case of the controlling shareholder's disposition of shares that carry management rights. Although thresholds are not typically prescribed for tag rights (ie, pro-rated tag-along), change of control is a common threshold (eg, where 50% or more of the shares of the target are disposed by the controlling shareholder).

10.3 IPO

Under the KRX regulations, a mandatory lock-up obligation is imposed for six months where shares were acquired from a company conducting an IPO, or the largest shareholder and its affiliates thereof, within one year from the date of the company's application for preliminary examination for listing.

However, if the relevant market is the KOSDAQ market, not the KRX market, the mandatory lock-up period is shortened to one month for private equity funds even if the relevant acquisition was made as above.

As discussed under **10.1 Types of Exit**, until several years ago the KRX did not allow the listing of companies in which the largest shareholder was a private equity fund, but today, the KRX allows IPOs of these companies, and private equity-led IPOs are no different.

Trends and Developments

Contributed by:
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Lee & Ko

Lee & Ko is Korea's premier full-service law firm, and its private equity team is held in the highest regard for its ability to handle complex transactions for both domestic and overseas private equity funds. Since the introduction of regulations governing private equity funds in the early 2000s, its private equity team has been a pioneer in the field, having successfully advised on the formation of the first private equity fund in Korea. With the growth of the private equity market in Korea, the firm's private equity team has grown into one of the largest and most trusted practices in the country. In recent years, it has garnered cutting-edge transaction experience and knowledge, having represented global and domestic private equity firms in some of the most high-profile M&A transactions in Korea.

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Current Overview of Private Equity Funds in Korea

Market share

Private equity funds account for a significant share of the M&A market in Korea. In 2022, transactions involving funds constituted close to 31.7% of the overall M&A market, which was an increase from 2021 levels (29.6% of the overall M&A market) and levelled with 2019 levels (31% of the market). Of the 1,123 deals reported in 2022, 356 involved funds. In 2021, the aggregate transaction value of these deals (USD60,126,000,000) represented 46.5% of the total combined value of all reported deals, including those not involving funds (USD129,250,000,000). Although the proportion of reported deals involving funds increased in 2022 (representing a staggering 34% of the total combined value of all reported deals), the aggregate transaction value of such deals (USD39,170,000,000) dipped.

In 2023, the Korean fund market experienced a net inflow of KRW68.2 trillion. The private equity fund sector in particular grew by 9.5%, amounting to KRW623.1 trillion in size. When combined with publicly offered funds, the total net assets of domestic funds amounted to KRW664.7 trillion, reflecting a 16% increase compared to the end of the previous year, and those of overseas funds amounted to KRW326.7 trillion, reflecting a 10.2% increase compared to the end of the previous year.

Earlier regulatory changes

The easing of regulations on private equity funds through the amendment of the Financial Investment Services and Capital Markets Act (FISCMA) in 2015 greatly contributed to the growth of private equity funds. At the time of the amendment of the FISCMA in 2015, the financial authorities significantly eased regulations by converting the prior registration scheme for private equity funds to an ex post reporting scheme and allowing strategic investors to invest in special-purpose companies established for investments and the utilisation of multi-level special-purpose companies. These regulatory changes provided the impetus for private equity funds to become one of the major players in the Korean M&A market.

Recent Trends in the Korean Private Equity Fund Market

Joint investments between private equity funds and strategic investors are on the rise

This trend stems from the amendment to the FISCMA in 2015 allowing for:

- the incorporation of multi-level special-purpose companies for investment purposes; and
- investment by strategic investors into special-purpose companies.

As joint investments with strategic investors came to the fore, funds that had previously focused on buyout transactions also began to invest as minority financial investors.

Strategic investors ‘ growing familiarity with private equity funds

As joint transactions by private equity funds and strategic investors are growing, strategic investors are becoming better accustomed to transacting with private equity funds. Accordingly, there has been a growing number of cases where strategic investors do not demand deposits or monetary penalties from the private equity counterparties and such compromises are reflected in the relevant documentation. Strategic investors are also becoming more aware of, and more understanding of, the needs of private equity investors in requiring W&I insurance in their exits in buyout deals.

Decrease in fund formation

Due to the sharp rise in interest rates, returns that investors could expect by investing in funds through leveraged finance have declined. Accordingly, there has been a global slowdown of fund formation and M&A activity involving funds, with deal volumes dropping by 4% as of the second half of 2022. As the M&A landscape in South Korea is not an exception to this global trend, the proportion of funds involved in M&A deals decreased from 41% to 32% in terms of deal volume, and from 47% to 34% in terms of deal value during the course of 2022.

Although this decreasing trend continued in 2023 as the total number of M&A deals decreased by 30% compared to 2022, we may be nearing the end of this trend as the number of deals increased by 20% from Q1 2023 to Q4 2023.

Blurring of boundaries

As private equity funds invest in start-ups like venture capital, and venture capital invests in large-scale like private equity, there is a blurring of the boundaries between private equity and venture capital in the M&A market in Korea.

Overseas private equity

In particular, overseas private equity funds making inbound investments in Korea are displaying the following trends.

- Overseas private equity funds are active in conducting not only large-scale investments and M&A, but also medium-scale and minority (pre-IPO) investments. In the past, overseas funds were mainly focused on control deals for the acquisition of management rights and were less attracted to minority investments, but there has been a turning of the tide on this point.
- In executing investments in Korean targets, overseas funds are becoming more active in seeking joint investments with strategic investors rather than making unilateral investments. These joint investments are arranged by overseas funds that believe synergies can be formed between the strategic investor and the target, thereby increasing the value of their investment.
- In selecting investment targets or conducting due diligence thereon, overseas funds are putting a spotlight on anti-bribery and corruption (ABC) and environmental, social and governance (ESG) issues. As ESG has become a central talking point in Korea, ESG matters have become key determinants in ascertaining the growth potential of investment targets.

Recent Updates to the Regulations on Private Equity Funds

Updates on merger filing

Previously, under the Monopoly Regulation and Fair Trade Act, the establishment of a private equity fund required a business combination report to be filed with the Korea Fair Trade Commission. However, the Monopoly Regulation and Fair Trade Act was amended on 6 February 2024, and the amended Act came into effect on 7 August 2024. According to the amended Monopoly Regulation and Fair Trade Act, if a company required to file a business combination report jointly participates with another company in the establishment of a private equity fund under the FISCMA and becomes the largest investor, this participation will be excluded from the business combination report requirement.

Consequently, starting from 7 August 2024, business combination reports for the establishment of private equity funds will no longer be required. However, this exemption only applies to the establishment of new private equity funds,

and the business combination report will be required in the following cases:

- a private equity fund invests in a target company; or
- a new limited partner invests in an already established private equity fund, or an existing limited partner makes an additional investment or acquires the interest of another limited partner.

However, in the case of a new limited partner investing in an already established private equity fund, or an existing limited partner making an additional investment or acquiring the interest of another limited partner, a simplified review process will apply, making the procedure less burdensome than for a private equity fund investing in a target company.

Updates on tender offers

If a private equity fund intends to invest by way of a tender offer, it must proceed in compliance with the procedures prescribed by the FISCMA. One of these requirements is to provide evidence of funds sufficient to satisfy accepted offers prior to the commencement of the tender offer, which in practice is burdensome for private equity funds due to the nature of the timeline of their capital calls (ie, within a certain period leading up to closing).

In the recent Osstem Implant transaction, a landmark tender offer deal in South Korea, Lee & Ko provided evidence of funds to regulators in the form of letters of commitment (which led to the regulators later revising the relevant regulations to expressly allow this form of evidence). In this way, investments by way of tender offer have become a more considered option for private equity funds. However, these letters of commitment must be issued by reputable domestic institutions such as pension funds or financial institutions. In practice, 20% of the total tender offer funds should still be deposited in advance along with the commitment letters.

Amendments to the Regulations on Private Equity Funds

The FISCMA previously distinguished private equity funds from hedge funds in the "private fund" category and allowed hedge funds to freely invest (except in the case of investments acquiring control over the target), while maintaining a complex regulatory matrix on permitted investment securities, methods and return periods for private equity funds. By way of example, private equity funds were only allowed to invest by participating in business management through the appointment of directors or investing in 10% or more of the shares of the investment target and were prohibited from investment by way of lending funds.

The previous regulatory regime under the FISCMA had therefore focused on the investment target and distinguished private funds thereby. However, the FISCMA was amended on 20 April 2021 and the amended law took effect on 21 October 2021.

Under the amended FISCMA, private funds are categorised as "general private funds" or "institutional private funds" and private equity funds under the previous law have transitioned to institutional private funds. Both types of private fund are allowed to invest freely, but the scope of investors for institutional private funds are limited to qualifying institutional investors, including financial companies and listed companies meeting certain requirements, and the offering procedure for general private funds, which are open to individual and general investors, have become more rigorous.

The most significant changes in the FISCMA amendment are therefore the change in regulatory framework from one categorising private funds based on the investment target to that of categorisation by type of investor, and the removal of restrictions on property management for private funds.

As a result of these changes, the general partners operating private equity funds are able to structure the management of these funds in various ways and so-called acquisition financing funds and mezzanine funds are likely to appear in the market. In the past, as investment by way of loans was not viable, private equity funds were restricted from being granted put options from the counterparties selling shares in M&A transactions.

The restrictions were put in place because put options, exercisable in the amount of the purchase price multiplied by a certain interest rate, were regulated by supervisory authorities as they were deemed to be loans in substance. However, under the amended FISCMA, all the restrictions on property management have disappeared.

Additionally, for institutional private funds, as investors that may take part in these funds are limited to financial companies, listed companies meeting certain requirements and other institutional investors, market entry of newly formed general partners that do not have ready access to these investors have become more impenetrable.

Under the current FISCMA, borrowing at the fund level was largely restricted and, as such, a private equity fund had to establish a special-purpose company to borrow funds and could not realistically borrow funds itself. However, the amended FISCMA has repealed this restriction to allow for borrowing at the fund level.

Under the amended FISCMA, the number of investors that may invest in private equity funds has expanded from 50 to 100 and this expansion is interpreted as a regulatory easement.

Amendments to the Regulations on General Partners

The amended FISCMA additionally prescribes regulations on fund-managing personnel affiliated with the general partners to allow only those who are essentially in charge of the fund management duties at financial institutions or general partners to become fund-managing personnel. As the FISCMA to date had not specifically provided any restrictions on fund-managing personnel, the fund-managing personnel could consist of not only those essentially in charge of fund management, but also those related to the private equity fund's investment target.

For example, an unseasoned general partner seeking to form a project private equity fund to invest in a certain company may have those with industry experience in the target's industry as fund-managing personnel as well. Under the amended FISCMA, these personnel can no longer become fund-managing personnel and only those directly responsible for the fund management may register as fund-managing personnel.

Regulations on general partners have also been strengthened so as that unlike in the past, where general partners were indirectly regulated by regulations on private equity funds, there are now various regulatory mechanisms that take direct measures for inspection on general partners under the amended FISCMA. This change likely reflects the intention of the Korean supervi-

sory authorities to further tighten the supervision on general partners going forward.

Finally, as mentioned above, as new restrictions are imposed on the types of investors that can participate in institutional private funds (PEF), newly established general partners that cannot receive investments from these investors have increased barriers to market entry.

SPAIN

Law and Practice

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Deloitte Legal offers private equity (PE) services as part of its specialised services in M&A, for which it can call on the expertise of more than 100 professionals. The firm's team all have considerable experience in advising PE funds, covering all the milestones of a transaction. Deloitte Legal's multidisciplinary approach, specialisation by industry, and strong global network and presence in more than 150 countries enable it to offer a complete range of M&A transaction services, including expansion processes, alliances and divestitures. The firm deals with legal, tax and regulatory issues, among others, which can be crucial for the success or failure of an investment. Clients benefit from Deloitte Legal's extensive experience in M&A, its understanding of PE/VC markets and industries, and its close collaboration with colleagues in other disciplines within Deloitte's global organisation.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

Private equity (PE) M&A transactions have reached record levels in recent years despite the uncertainty generated by the COVID-19 pandemic and major international conflicts (Ukraine-Russia and Gaza-Israel).

Record Levels of PE Investment and VC Transactions

According to the Spanish Venture Capital and Private Equity Association (SPAINCAP), Spanish PE capital investment recorded its best ever figures in 2022. This was achieved despite the changing macroeconomic landscape and the uncertainty caused by geopolitical conflicts, driven by favourable investment opportunities.

Pursuant to the information provided by SPAINCAP, FY 2023 was marked by a volatile geopolitical situation, and the Spanish VC and PE industry remained cautious, waiting for interest rates and the macroeconomic environment to become more favourable for investment. Nevertheless, VC and PE investments totalled EUR6,709 million in Spanish companies (844 investments) last year, returning to pre-pandemic levels. However, this represents a 27.4% decrease from the amount recorded in 2022 (EUR9,238 million). Nonetheless, and despite the difficulties for M&A activity worldwide, the value of VC and PE investments in Spain was among the highest on record.

In this context, it is relevant to highlight that a total of 569 Spanish companies (90% of SMEs) received VC and PE funding in 2023. Regarding the number of investments in 2023, and notwithstanding the challenging environment, 54% of investments were made in new companies (6% less than in 2022).

Between 2018 and 2023, the VC and PE sector has funded approximately 3,637 companies, of which approximately 90% are SMEs.

Major Market Challenges

As mentioned previously, FY 2023 was characterised by geopolitical uncertainty, price volatility, and high financing costs and inflation. It should be pointed out that PE funds now assess acquisitions much more carefully, and with more thorough due diligence, to avoid risk exposure post-transaction.

In this sense, and pursuant to information provided by SPAINCAP, VC and PE activity in the first few months of 2024 was similar to that in 2023, yet was influenced by high interest rates and geopolitical uncertainty. In the first quarter of 2024, VC and PE investments totalled EUR1,191 million (229 investments), representing a 42% decrease from the first quarter of 2022. However, experts agree that several factors continue to drive investment: the availability of dry powder for VC and PE general partners, numerous companies being poised for launch, strong investor appetite and the commitment of international funds to the Spanish market. Once the announced interest rate adjustment begins and macroeconomic indicators stabilise, investment activity is expected to experience a gradual resurgence starting in the second half of 2024.

Warranty and Indemnity (W&I) Insurance

In this context, the use of W&I insurance is likely to continue to grow in Spain, not only through PE funds but also through industrial players that seek to ensure clean transactions.

W&I insurance has become widespread in Spain, not only in PE investment but also – and in fact mainly – in the context of PE fund divestments, to ensure a clean exit (95% of PE divestments included the execution of W&I insurance); it is more common in transactions valued over EUR 100 million due to the cost.

Technology in M&A Processes

It should also be noted that the use of technology in M&A processes has been consolidated, both at the negotiation level (via Zoom or Teams negotiation meetings) and at the signing level, through electronic authentication platforms.

1.2 Market Activity and Impact of Macro-Economic Factors

According to a recent SPAINCAP report, the following were the most active sectors in 2023:

- healthcare, which received 31.3% of funds invested, and for which the most significant transactions involved IVI-RMA Global, Palex Medical, Inke, Health time, Farmalider and Vitaldent;
- industrial products and services, which received 24.1% of funds invested, and for which the most significant transactions involved Gestión Tributaria Territorial, Trison, BCN Visuals and Abrasivos Manhattan; and
- IT, which received 8.1% of funds invested, and for which the most significant transactions involved Kzemos Technologies, Wallapop and Cabify.

By number of companies, the IT sector ranked first (representing 34.4% of the total companies receiving investments in 2023), followed by healthcare, biotechnology/genetic engineering (each accounting for 10% of the total), industrial products and services, and consumer goods (each accounting for 8% of the total).

During FY 2023, PE investment maintained its focus on sectors such as digitalisation, but also focused on sectors that are in the process of recovery such as consumer products and industry.

It should also be noted that the war in Ukraine has led to a decrease in Russian gas consumption, which has provided a great opportunity for the renewable energies sector to consolidate its position as an alternative to gas. In this regard, price stabilisation formulas through power purchase agreements (PPAs) may materialise in significant M&A transactions.

As interest rates increased during the past few years, borrowing costs for businesses and investors escalated, leading to tighter credit conditions and reduced access to cheap financing. This has made it more challenging for PE firms to fund acquisitions, resulting in a slowdown in deal activity in the country.

However, despite such challenges, certain sectors have shown resilience and continue to attract PE interest. IT, healthcare and renewable energy have been among the bright spots, where these industries demonstrate the potential for growth.

In response to the changing landscape, PE investors have become more selective in their decisions, focusing on businesses with stable cash flows, strong management teams and solid growth prospects.

In conclusion, interest rates and macro-economic factors have created headwinds for PE deal activity in Spain over the past year. However, certain sectors remain attractive, and firms have adapted their strategies to navigate the challenging economic conditions. The overall effect has

been a slowdown in deal activity, with a greater emphasis on prudent investment choices.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

One significant legal development in Spain that will have an impact on PE investments and transactions is the enactment of the Royal Decree Law 5/2023, which introduced a series of measures in response to the economic and social consequences of the conflict in Ukraine, supporting the reconstruction of La Palma Island, addressing vulnerability situations, transposing EU directives on corporate structural changes and work-life balance, and enforcing EU law.

The law, in effect as of 29 July 2023, introduced certain changes to the regime governing structural modifications, which have an impact on PE investments. As a result, the expert reports requested for leveraged mergers subsequent to the leveraged acquisition of a target company no longer have to address the "existence of financial assistance", thus simplifying the process and avoiding controversies related to the evaluation of financial assistance in such transactions, where it is difficult for experts to determine whether financial assistance is fair and equitable.

Removing this requirement confers several benefits for PE funds engaging in leveraged mergers in Spain:

- it allows PE investors to execute leveraged mergers faster and more efficiently, without the need for extensive evaluation of financial assistance;
- it reduces costs related to additional evaluations and advice, which will enhance the return on investment (ROI) for PE and allow allocation of resources to other strategic areas; and
- it permits greater flexibility in the structuring of leveraged mergers, aligning them with investment strategies and transaction-specific needs as well as with the requirements of finance providers (where it is a common requirement under such financings to merge the target company and the acquiring vehicle).

In addition, and among other measures, regulations regarding Spain's electric power supply also changed, mainly to minimise the impact of the war in Ukraine, enhance the use of renewable sources and regulate the remuneration of the sector. PE funds have actively followed these new regulations despite the uncertainty generated by continuous change.

Furthermore, regulations concerning foreign investment regulations and foreign subsidies regulations were introduced; these are explained in **3.1 Primary Regulators and Regulatory Issues**.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

In general terms, M&A transactions are not subject to restrictions or regulatory filings in Spain, with the following exceptions.

Merger Control Regulations

These set out the need for the approval of the National Markets and Competition Commission (*Comisión Nacional de los Mercados y la Com-*

petencia or CNMC) when certain thresholds in the target's market share and turnover are met. Transactions are suspended until this approval is issued. The CNMC may mandate the fulfilment of certain actions as a condition to complete the relevant transaction (eg, carve-out of certain assets or business units).

Foreign Investment Regulations

These were issued in March 2020 and in 2023. A Royal Decree on foreign investment came into effect on 1 September 2023. This Royal Decree has two crucial aspects:

- the scope of investment operations to be reported to the Foreign Investment Registry is modified; and
- the regime for the suspension of liberalisation of foreign direct investments (FDIs) in Spain is clarified and developed, requiring administrative authorisation in certain cases.

As a result of these regulations, any investment into Spain carried out by residents of countries outside the EU and the European Free Trade Association (EFTA), or carried out by residents of the EU or EFTA whose ultimate beneficiary owner lies outside the EU or EFTA, needs prior authorisation by the Spanish government if the foreign investment meets the following conditions.

- The foreign investor will hold a stake equal to or greater than 10% of the share capital of a Spanish company, or will effectively control a Spanish company. Pursuant to the regulation, some types of operations that were not covered by the previous Royal Decree are included in the notification obligation, such as:
  - (a) acquiring shares in closed-end investment schemes or collective investment schemes resulting in a stake equal to or exceeding 10% of the entity's capital;
  - (b) equity contributions that do not increase the share capital, provided the contributor holds a stake equal to or exceeding 10%;
  - (c) intra-group financing to companies or branches exceeding EUR1 million with a repayment period longer than one year; and
  - (d) real estate investments, although the new regulations set the thresholds at EUR3 million for Spanish investments executed in foreign countries and EUR500,000 for foreign investments in real estate assets in Spain.
- It is directed towards a "strategic sector".
- It is greater than EUR1 million.

Strategic sectors include, among others, critical physical or virtual infrastructures (the energy, health, water, transport, communications, communications media, processing and data storage, aerospace, military, electoral and financial sectors), critical technology, essential commodities (such as energy or raw materials and food safety), sensitive data and the media.

The aforementioned investments require prior authorisation from the Spanish government; otherwise, they have no legal effect whatsoever until legalised and entail an infringement punishable by law.

Data for Spain shows that foreign investment increased by 12% in FY 2023 compared to FY 2022, surpassing EUR28.215 million.

According to a report published by the Ministry of Industry, Consumption and Tourism, during FY 2023, 97 transactions were submitted for prior authorisation. Nine applications were closed as there was no need for approval, and 80 of

the remaining 88 applications were approved without mitigation measures due to the absence of significant risks for security, health, or public order. In eight cases, the investments were approved with mitigation measures.

EU Foreign Subsidies Regulations

On 23 December 2022, Regulation (EU) 2022/2560 of the European Parliament and of the Council of 14 December 2022 on foreign subsidies that distort the internal market (FSR) was published in the DOUE, which empowers the European Commission to investigate the granting of subsidies from third countries to companies operating in the EU that may cause distortions in the internal market and undermine the conditions of competition within the internal market. The FSR entered into force on 12 January 2023 and has been applicable since 12 July 2023.

FSR provides for a gradual implementation that has allowed both operators and the European Commission to prepare for the new regime. As of 12 October 2023, the regime of prior notification and authorisation of certain concentrations and bids submitted in public procurement processes that meet a series of specific thresholds came into force. In this context, FSR introduced mandatory notification requirements for certain transactions where the acquired company, one of the merging parties or the joint venture generates an EU-wide turnover of at least EUR500 million, and the foreign financial contribution exceeds EUR50 million. PE firms involved in large transactions must be prepared to notify the European Commission about foreign subsidies.

FSR covers a wide range of economic activities, including mergers, acquisitions and public procurement, making it highly relevant to PE transactions. It applies to any company engaging in these activities within the EU, including those operating in Spain.

In this regard, the European Commission has the authority to investigate and assess the impact of foreign subsidies on competition. If a PE firm has received significant foreign subsidies, the Commission will evaluate whether these subsidies could distort the internal market. This review can lead to delays in the transaction process and additional compliance requirements.

Consequently, PE firms need to conduct thorough due diligence to identify any foreign subsidies received by the target companies or themselves.

Other Tightly Regulated Sectors

Other tightly regulated sectors include banking, insurance and utilities, which are all subject to regulatory oversight from the relevant supervisory authority.

Regarding sovereign wealth investors (when they are involved as fund or deal co-investors), scrutiny is generally higher; being state-owned, they often raise national security concerns, especially if they are from countries with strategic or political interests that may not align with Spain's. The involvement of sovereign wealth investors can lead to heightened scrutiny to ensure that investments do not compromise national security or critical infrastructure.

Additionally, Spain has specific regulatory frameworks in place that address FDIs, particularly in sectors deemed critical to national security, public order and public health. The involvement of sovereign wealth funds can trigger reviews under these frameworks. For example, the Spanish government might scrutinise investments in sectors such as energy, transportation,

telecommunications, and defence more closely if a sovereign wealth investor is involved.

4. Due Diligence

4.1 General Information

Due diligence is normally carried out through a virtual data room into which the relevant requested documentation is uploaded. Due diligence procedures also imply a constant question-and-answer process with the management of the target company. It is usual for due diligence procedures to be co-ordinated by a corporate finance team.

The scope of due diligence usually depends on the size and industry of the target, as well as on the type of purchaser, who may demand a wide spectrum of due diligence ranging from narrow-scoped to full and comprehensive. PE funds generally request the full scope of due diligence, including:

- financial due diligence;
- legal due diligence;
- tax due diligence;
- labour due diligence; and
- technical due diligence (among others, when the target operates in the real estate or energy industry).

Types of due diligence that are not very common but are increasingly being included in the scope of due diligence are compliance, corporate social responsibility, ESG and cybersecurity.

Contingencies Identified in Financial, Tax and Labour Due Diligence

In so far as they typically include an estimated amount per contingency, these contingencies are typically addressed through:

- valuation/consideration adjustments;
- specific indemnities included in the share sale and purchase agreement (SPA); and/or
- guarantee mechanisms (escrows, bank guarantees, etc).

Contingencies Identified in Legal Due Diligence

For contingencies in legal due diligence, which are often qualitative in nature, remedies should be adopted before or after the transaction. They are therefore usually addressed through:

- remedies applied by the seller before closing;
- remedy obligations for the seller included in the private share SPA, which must be applied after closing or between signing and closing;
- general representations and warranties (R&W) included in the SPA; and
- specific indemnities included in the SPA.

In addition, given the current uncertainty, PE funds are increasingly requesting the revision of material adverse change (MAC) clauses in certain contracts that are important for the target company.

Due Diligence Findings

Due diligence reports are frequently divided into an executive summary/red flag section, in which the contingencies identified are highlighted, and a descriptive section in which each contingency and other aspects of the target company are detailed.

Expert meetings between the purchaser's and seller's advisors are usually held during the due diligence process.

Contingencies identified will thereafter be discussed among the parties to determine the seller's liability in the SPA. The purchaser's knowl-

edge of the target company, acquired during the due diligence process, is a frequent point of discussion among the parties (ie, whether the seller's liability would have to be limited by the buyer's knowledge).

4.2 Vendor Due Diligence

The completion of a vendor due diligence report depends primarily on the size of the target company and whether the sale is made through an auction process. It is therefore more common in medium- and large-cap targets.

In auction processes, regardless of whether a vendor due diligence report is to be prepared, it is common to provide the potential bidders – at a preliminary stage – with a fact book that highlights key aspects of the target and where certain contingencies can be identified.

If a vendor due diligence report is eventually prepared, it is typically provided to potential bidders, such as PE funds, to enable them to assess the target company's strengths, risks and growth prospects, ensuring informed decision-making during the transaction process.

Advisers typically rely on vendor due diligence reports, although it is common for buyers to perform buy-side "confirmatory due diligence", which "challenges" the contingencies identified in the vendor due diligence and covers additional matters.

5. Structure of Transactions

5.1 Structure of the Acquisition

Private SPAs

The private SPA continues to be the most common form of PE transaction. Court-approved schemes are reserved for liquidation procedures, and tender offers are limited to listed companies, so they are not generally part of a PE transaction.

In Spain, private SPAs are usually notarised before Spanish notaries public who, among other functions, confirm the date and the capacity of the parties and – as the case may be – their legal representatives, to execute the transaction documents. Notaries public also guarantee that transactions are carried out in accordance with the law and that the parties understand and agree to the terms of the transaction. In some deals, their presence is mandatory (such as the acquisition of shares of limited liability companies), but in any case they are typically involved in a PE deal, as the legal certainty that they provide to the transaction benefits all the parties involved. After the closing of the transaction, the deeds granted before the notary acquire probative value and become enforceable titles for all the purposes provided for under the applicable Spanish law, and the parties may request copies of said deeds at any time.

Bilateral and Auction Processes

PE deals can be run as bilateral or auction processes, depending on the specific transaction.

PE transactions run as auctions with multiple prospective bidders have decreased in number since 2022; however, in 2023, the number of PE transactions run as auctions increased slightly, returning to typical levels.

Competitive auction processes are standard for medium- and large-cap companies, while in the case of small-cap companies, the transaction usually entails a bilateral negotiation between the seller and the buyer.

Auction processes tend to slightly favour the seller, who seeks to maximise the selling price and to achieve the best contractual terms and conditions in the agreement; however, this varies depending on the characteristics of the transaction (industry, types of parties involved, etc).

Share Deals and Asset Deals

Share deals continue to be far more frequent than asset deals. Whereas in share deals the acquisition of the shares of a company entails the indirect acquisition of all its assets, rights and liabilities, in asset deals there is a need to:

- precisely detail in the asset purchase agreement each and every asset and right that is being transferred (assets and/or rights that are not detailed will remain with the seller); and
- depending on the transfer regime of the specific asset and/or right, obtain consent either from the counterparties to the agreements that are being transferred or from public authorities.

Ancillary Documentation

PE transactions involve the execution of a SPA and, if there are additional shareholders, a shareholders' agreement is needed between the PE fund special purpose vehicle (SPV) and the other shareholders, particularly those who manage the company, to regulate the relationships between shareholders and between the shareholders and the company.

Likewise, it is also common to formalise different types of guarantee agreements (eg, in favour of the seller as a guarantee of payment of the selling price when it is retained by the buyer and/or deferred, or in favour of the buyer when a contingency has been identified from which the buyer wants protection).

A management incentive plan (MIP) is also very common in PE transactions. These incentive plans aim to increase the value of the target company and its affiliates by providing an extraordinary incentive to the target's managers (independent from and additional to their employment or mercantile relationship with the company) in exchange for maximising the value of the company in a liquidity/exit event. The amount of extraordinary remuneration ("ratchet") usually depends on the ROI or the internal rate of return (IRR) of the PE fund.

5.2 Structure of the Buyer

PE funds almost always directly buy the target company through an SPV incorporated in Spain as limited liability companies ("SL companies"). PE funds prefer such companies for the following reasons:

- favourable capital requirements (EUR1 to incorporate an SL company);
- the shareholders' liability is limited to the amount of their contributions; and
- a SL company provides management flexibility and is less expensive than a public limited company (*sociedad anónima* or SA).

Usually, SPVs are directly controlled by a PE fund (if the fund is located in Spain) or by a foreign holding entity ultimately controlled by a fund located in a tax- and investment-friendly country with which Spain has a favourable double-taxation treaty.

It is unusual for a PE fund to be a party to the transaction documents, except for the equity commitment letter agreeing to fund the target.

5.3 Funding Structure of Private Equity Transactions

Most PE transactions continue to be financially leveraged, involving a combination of equity and debt (the proportions depend on the size of the transaction and the business involved).

The funding structure normally consists of partial financing of the acquisition, although the purpose of the financing could be to refinance existing debt or to partially finance investments in capital expenditure (capex).

In those funding structures, banks and/or alternative debt providers usually act as lenders. It is customary for the due diligence report to be shared with and analysed by the lenders as a condition precedent to the signing of the facility agreement. The lenders may require reliance on the due diligence report.

Depending on the characteristics of the acquisition, lenders may require collateral or the personal guarantee of the parent company.

The contribution of public domestic (Centro para el Desarrollo Tecnológico y la Innovación, E.P.E (CDTI), *Compañía Española de Financiación del Desarrollo* (COFIDES), Empresa Nacional de Innovación, SME, S.A. (ENISA), and *Instituto de Crédito Oficial* (ICO)-AXIS)) and European funds (next-tech funds) to VC and PE must be also stressed. The public-private collaboration has been an essential relationship for years, helping PE general partners close new vehicles.

According to SPAINCAP, despite the change in monetary policy by central banks and the consequent change in interest rates, leveraged transactions stood out from the other types of transactions, and 54% of PE transactions were financed with debt in FY 2023.

Providing comfort to the purchaser regarding the debt-funded portion of the purchase price is crucial to ensure a successful and smooth PE transaction in Spain. The specific approach to secure debt financing may vary depending on the deal's complexity, the parties involved, and the prevailing market conditions. Purchasers can find comfort through mechanisms such as a commitment letter from lenders, presenting a detailed debt financing plan, having binding agreements with lenders, and including contingency provisions in the purchase agreement to adjust, retain and/or defer the payment of the price or terminate the deal if needed.

When the purchaser is an SPV, the sellers might request an equity and/or debt-commitment letter from the PE fund.

Acquired Stake

The most common PE transaction for PE funds continues to be one in which they buy 100% of the target company's capital stock or take a majority shareholding through a share purchase, with the key managers remaining as managers and minority shareholders. In 2023, there was a meaningful increase in the number of PE deals where a PE fund took a majority stake.

5.4 Multiple Investors

PE deals involving multiple investors continue to be unusual in Spain, except for transactions involving large-cap companies. Exceptional PE transactions involve other investors alongside the PE fund, but these do not happen very frequently (although they are common in VC deals) and are normally driven by the modus operandi of the PE fund rather than being a general form of PE transaction.

External co-investors in such transactions will usually have very limited political rights in the

target company, which will be governed by the PE fund.

In Spain, a consortium of multiple investors with both PE funds and corporate investors is less prevalent compared to other investment structures. PE investors prioritise active ownership and value creation, while corporate investors focus on strategic investments related to their core business objectives.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Completion and locked-box accounts are the predominant consideration mechanisms in PE transactions in Spain, together with the fixed-price mechanism. A mechanism combining the locked-box and completion accounts mechanisms is also commonly used (mostly in more complex transactions and those of higher value).

Completion Accounts Mechanism

In this mechanism, the initially agreed price is subject to a potential post-closing adjustment. On the closing date, the seller's auditor usually determines the parameters that have been used to agree the equity value (mainly net debt and working capital). The purchaser usually has a period of time after the closing date (normally several months) to review those parameters and, where appropriate, challenge the calculation of the purchase price.

Locked-Box Mechanism

The locked-box mechanism continues to grow in popularity and was again the most used pricing mechanism in 2023 for both sell-side and buy-side transactions.

This mechanism implies that the parties agree on a fixed price based on the financial statements closed on a specific reference date. Usually, the parties agree that the financial statements must be audited, or at least agreed between the parties.

The purchase price can then be adjusted in the case of leakages, that is, actions executed by the seller between the reference date and the closing date that are not within the ordinary course of business.

Earn-Outs, Deferred Consideration and Roll-Over Structures

Earn-outs, deferred consideration and roll-over structures are relatively common in PE transactions in Spain.

With the aim of maximising returns within a specific investment period, PE funds might use mechanisms such as earn-outs or deferred consideration to bridge valuation gaps or incentivise future performance, which helps parties overcome their differing expectations about a company's future performance; this is particularly important in times of uncertainty. These mechanisms are often used to incentivise sellers to remain involved in the business and increase the purchase price, contingent on achieving certain performance milestones or future financial results (most earn-outs are linked to EBITDA or, more generally, the company's benefits).

PE funds' involvement in a transaction may lead to more sophisticated contractual protections related to consideration mechanisms, such as earn-out provisions tied to measurable financial or operational targets, and detailed conditions for deferred consideration payments.

PE deals wherein a PE fund takes a majority stake are also structured using a roll-over formula, whereby the PE fund buys the target company through an SPV, after which the seller reinvests in the SPV (usually through a capital increase).

6.2 Locked-Box Consideration Structures

In the event of the application of a locked-box structure, the seller usually tries to charge interest on the price after the date of opening of the locked-box account (ticking fee). However, such interest is heavily negotiated, and it is common for the parties to agree that no interest will apply.

Regarding interest charged on leakages, the usual provision negotiated would be to directly reduce the purchase price on a euro-for-euro basis when leakages arise prior to closing. If any leakages arise post-closing, interest could be charged on the leakage amount, although this is not a common practice in Spanish PE transactions.

However, the use of equity tickers and adding interest to the leakage amount continues to become more prevalent in Spanish PE transactions.

6.3 Dispute Resolution for Consideration Structures

In both structures typically used in Spain (locked-box and completion accounts), it is common to establish a dispute-resolution mechanism.

In the most common dispute-resolution mechanism, the parties will initially negotiate in good faith during a determined period of time, with the aim of reaching a mutually agreeable resolution, and in the event of lack of agreement, the decision will be made by an independent expert selected in accordance with the SPA's conditions (usually an international audit company). The independent expert's opinion is usually binding for the parties, excluding the possibility of submitting the dispute to a court or arbitration unless the independent expert is grossly negligent.

The application of the general dispute resolution system established by the parties – and governing the SPA (court or arbitration) – is very uncommon.

Likewise, in transactions with complex consideration structures, parties may consider including more tailored and detailed dispute-resolution provisions in the purchase agreement. This could involve appointing a dedicated expert or using other alternative dispute-resolution methods to address any potential disagreements regarding the achievement of performance targets or the calculation of contingent payments.

6.4 Conditionality in Acquisition Documentation

The most common regulatory condition of PE deals is the need for regulatory approvals (particularly antitrust clearance) and FDI screening (where a preliminary analysis is needed for most deals involving international parties). In 2023, many deals required a preliminary analysis of the need for regulatory approvals but, based on the conclusion of such analysis, most PE transactions ultimately did not need to include a condition precedent in the SPA for that purpose. Likewise, as indicated in **3.1 Primary Regulators and Regulatory Issues**, in the event of the application of FSR, authorisation shall be obtained from the European Commission if one of the parties involved in a transaction received financial contributions (such as a subsidy) from

a third country, which would be an additional regulatory condition precedent.

Aside from regulatory approvals, other conditions could include:

- the buyer's financing of the acquisition;
- obtaining third parties' consent for significant agreements containing change-of-control provisions of the target (the termination of which would have a significant impact on the acquired business); and
- fulfilling pre-closing covenants, such as carve-out or reorganisations that may need to occur before closing the transaction or executing, terminating or maintaining certain key agreements.

MAC provisions are rarely used as a condition precedent but have become more relevant since the COVID-19 pandemic.

Approval of the seller or the purchaser at the general shareholders' meeting is likely to be a requirement to execute the transaction (especially when the transferred assets represent 25% of the purchaser's or seller's assets, according to applicable Spanish law) but is not included as a condition precedent to execute the agreement.

6.5 "Hell or High Water" Undertakings

Due to their inherent nature, PE funds typically adopt a highly aggressive negotiating position, and PE purchasers are usually very reluctant to accept any "hell or high water" undertakings. It is not, therefore, very common to include such undertakings in PE transactions, although a trend towards sellers trying to push the execution risk onto the purchaser through such clauses is becoming apparent. These provisions usually apply to antitrust, foreign investment and foreign subsidies (according to new EU foreign subsidies regulations). Authorisations conditions precedent (CP) might stipulate that the parties must accept the conditions imposed by the authorities, unless they are overly burdensome or exceed certain limits, and could require the purchaser to adopt the required measures – including the execution of divestments – in order to close the transaction.

6.6 Break Fees

In Spain, break fees and reverse break fees have typically been very rare in PE transactions. In SPAs, sellers are hesitant to accept any walk-out rights other than the CPs previously negotiated and agreed by the parties. Notwithstanding this, break fees provisions were included in 25% of transactions with deferred closing in 2023. The penalty is typically linked to the purchase price and varies depending on the particularities of the transaction; thus, the percentage of the purchase price to be paid as a penalty varies, at times reaching 10% or 15% while at other times more symbolically being below 1%.

6.7 Termination Rights in Acquisition Documentation

As a general rule, SPAs exclude the application of Spanish law and are governed by their specific provisions. Accordingly, an acquisition agreement cannot be terminated for a legal reason other than the provisions agreed therein (except in cases of wilful misconduct), the application of which cannot be excluded by the parties. Common provisions of termination of a SPA usually include the following.

- Lack of fulfilment of the CPs set out in the SPA prior to the relevant long-stop date. Notwithstanding this, the parties might find an amicable way to proceed with closing and, given that CPs (if not regulatory) can be waived by the parties, it is very uncommon for

either party to terminate or walk away from a signed SPA. As an exception to the foregoing, in energy (greenfield) sale-and-purchase PE deals, if the ready-to-build status condition precedent is not met prior to the relevant long-stop date, the parties would normally walk away from the agreement.
- MAC clauses, which are not very common in Spain. PE sellers are very reluctant to accept any MAC clauses, as these significantly reduce the certainty of the deal. However, "soft" MAC clauses (which refer to macroeconomic situations that are unlikely to materialise) have been introduced in some SPAs as a consequence of the impact of COVID-19 and major international conflicts (Ukraine-Russia and Gaza-Israel).

6.8 Allocation of Risk

There is no general rule for the allocation of risk, so risk allocation varies and needs to be analysed on a case-by-case basis. In general terms, risk allocation favours the seller.

In competitive auction processes, especially where a PE seller is involved, SPAs are drafted in a seller-friendly manner, meaning that the scope of R&W insurance is narrowed and the quantum is also limited. In PE transactions in which the PE funds are the purchasers, the sellers usually grant business and tax R&W; alternatively, R&W insurance is agreed.

In the case of a PE seller, R&W insurance basically refers to capacity, the title to the shares being sold and the absence of *liens* or encumbrances over the shares. It is common for the management team to grant the R&W, which can be dealt with in a separate document known as the management warranty deed. In the case of a trade seller, a more complete set of R&W is usually agreed (including business-related R&W).

In Spain, the impact of a buyer's actual or deemed knowledge on claims for breach of warranties is usually negotiated under SPAs. The most common limitation on liability for a seller includes full disclosure of the data room. On some occasions, as a consequence of the due diligence exercise, known issues also limit the liability of the seller. In the event that the PE fund sells, an anti-sandbagging clause is most common.

6.9 Warranty and Indemnity Protection

R&W under a SPA include the following categories.

- Fundamental R&W – this mainly refers to the existence of a valid target, ownership of the shares, the capacity of the parties, the absence of conflict, lack of insolvency and the absence of *liens* or encumbrances over the shares being sold/acquired. For these fundamental R&W, liability would only be capped at the purchase price, and may even not be limited at all, and in the case of several sellers, the most common liability regime is individual instead of joint liability.
- Business R&W – this refers to all kinds of aspects of the business of the target (including those relating to the accounts, main contracts or agreements to which the target is a party; compliance with tax obligations; litigation; employees; and the conducting of business). In exits, PE funds are reluctant to grant these business R&W, and in some cases, they are granted by the management team even if the team's liability is often capped at a symbolic quantity in the management warranty deed or replaced by the agreement of a W&I insurance (or if the liability was capped at less than 1% of the purchase price without agreement regarding W&I insurance).

As the granting of business R&W is an essential requirement for the purchaser to enter into a SPA, the uptake of W&I insurance has increased in recent years, as detailed in the subsequent section.

Limitation Provisions

The liability of sellers under SPAs is usually limited quantitatively and temporally. However, those limits change depending on whether there is an investment or an exit, and on whether W&I insurance is taken out.

In an investment by a PE, the following applies.

- Fundamental R&W are in all, or almost all, cases limited to the purchase price or even not limited at all.
- Business R&W are normally subject to certain time and quantitative limitations. Time limitations usually range from 12 to 24 months after the closing of the transaction (except for any tax, employment or environmental warranties, which are usually limited to the relevant statutory limitation period). Quantitative limitations could include the following.
  - (a) A cap – the seller's maximum aggregate liability to the purchaser may not exceed a certain amount.
  - (b) De minimis – by virtue of this limitation, only those damages that, when individually considered, exceed a certain amount can be claimed by the purchaser. Usually, when a de minimis amount is agreed, a series of claims arising from facts or circumstances that are substantially the same can be accumulated.
  - (c) Basket/deductible – the seller's obligation to compensate the purchaser is not enforceable until the damages exceed a certain amount. When exceeding this amount, the seller could be liable for the excess (deductible), or from the first euro (basket).

In auction processes, liability for known issues is normally excluded, and general disclosure of the data room against the R&W is also very common. Specific indemnities are usually included in the SPA, or in a side letter signed by the seller and the purchaser, to ensure specific protection against the known issues arising from the due diligence exercise. Furthermore, specific indemnities are not usually subject to any limitation and do not have to follow the claim procedure negotiated under the SPA, or at least enjoy higher quantitative and temporal limits.

6.10 Other Protections in Acquisition Documentation

Escrow or deferred prices are only common when the purchaser is a PE fund, and in the event of deferred prices or any sort of price retention, sellers usually require a guarantee for the payment. These remedies are typically used for contingencies whose statute of limitations (the date on which the relevant contingency/risk disappears) is clearly determined in the applicable law, such as labour or tax liabilities. PE sellers are usually unwilling to accept escrow or any sort of price retention.

W&I insurance is becoming increasingly common in PE transactions; in fact, it is the most widely used remedy in these transactions, being included in more than 50% of deals, although it still has certain drawbacks such as the additional costs of the transaction and the exclusion of certain known issues. W&I insurance is typically used in relation to the business R&W (including the tax R&W) and, in some cases, also in relation to the fundamental R&W.

6.11 Commonly Litigated Provisions

Litigation provisions are always introduced in the SPA. Disputes that are not solved amicably may be solved by the courts, which is the most widely used dispute-resolution mechanism, or by an arbitrator.

Regarding any consideration mechanisms or earn-out discussions, PE transactions usually agree to refer these to an external expert appointed in accordance with the provisions previously set out in the SPA.

Apart from those referring to consideration mechanisms or earn-outs, the most commonly litigated provisions refer to liability for breach of R&W granted by the sellers.

7. Takeovers

7.1 Public-to-Private

Public-to-private (P2P) transactions continue to be somewhat uncommon in Spain, since the number of listed companies is relatively low in comparison with other jurisdictions such as the UK and the USA.

P2P transactions in Spain are still usually carried out by:

- private investors holding large equity stakes in a listed company as a result of consecutive acquisitions over time; and
- in what seems to be an emerging trend in the market, PE investors (acting both individually and as a pool of different PE investors).

The rationale behind these P2P transactions is usually:

- to lower the management costs of the listed company by not having to comply with all the obligations imposed on listed companies by the law and market regulations; and
- based on valuation reasons (when the prices of unlisted companies begin to surpass those of listed ones).

The Spanish legislation on takeover bids states that the governing bodies and management of the target company, any delegated or empowered body thereof, their respective members, the companies belonging to the target company's group and anyone who might act jointly with the foregoing shall:

- remain passive during the execution of the takeover bid; and
- obtain prior approval at the general shareholders' meeting before taking any action that may prevent the success of the bid, with the exception of seeking other bids, in particular before initiating any issue of securities that may prevent the offeror from obtaining control of the offeree company.

Notwithstanding this, companies may not apply the provisions described previouslywhen they are the subject of a takeover bid made by an entity that does not have its registered office in Spain and is not subject to such rules or equivalent rules.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Any transaction by virtue of which a shareholder reaches, exceeds or falls below a voting right stake threshold of 3%, 5%, 10%, 15%, 20%, 25%, 30%, 35%, 40%, 45%, 50%, 60%, 70%,

75%, 80% or 90% in a listed company must be notified to that company, and to the market regulator (*Comisión Nacional del Mercado de Valores* (CNMV)).

When the shareholder is a tax-haven resident, these percentages are lowered to multiples of 1% (1%, 2%, 3%, etc).

In the case of mandatory tender offers, the person acquiring control of any public company shall communicate it to the CNMV in order to submit the relevant offer to the remaining shareholders. The voluntary tender offers will be communicated to the CNMV once the bidder adopts the resolution to submit the offer.

Once the tender offer has been announced, any acquisition of voting rights reaching or exceeding 1% shall be communicated to the CNMV. Regarding shareholders, anyone holding at least 3% of the share capital of the company shall communicate any change in the percentage.

7.3 Mandatory Offer Thresholds

Mandatory takeover bids are required when a person acquires "control" of a listed company. In such event, the shareholder acquiring control must make a bid for 100% of the issued shares of the listed company at a fair price (ie, a price not lower than the highest price that the offeror paid or has agreed to pay for the same shares during the 12 months prior to the announcement of the bid).

Control is gained when a person:

- acquires, directly or indirectly, a percentage of voting rights equal to or greater than 30%; and
- appoints, within 24 months of the acquisition of the listed company shares, more than half of the members of the board of directors, even if the person's holding stake is lower than 30%.

A breach of duty pertaining to a takeover bid (ie, failure to make a takeover bid, late submission of a takeover bid, or submission of a takeover bid with material irregularities) might entail the following.

- Suspension of the voting rights held in the listed company.
- Public sanction by the CNMV for a very serious infringement, including:
  - (a) a fine up to EUR600,000 or 5% of the offender's own resources;
  - (b) suspension or limitation of the transaction or activities that the offender may carry out in the market for up to five years; and
  - (c) publication of the infraction in the Spanish official gazette.

In the context of a takeover bid, consolidation and attribution of shareholding issues are relevant for PE-backed bidders, particularly concerning the treatment of target shares held by affiliated or related funds and portfolio companies. This applies in the following ways.

- Mandatory takeover bid: the 30% of voting rights' threshold applies whether they are held by a single person or by a group of companies.
- Affiliates: PE often manages multiple funds or entities. During a takeover bid, it is essential to consolidate the shareholdings of all affiliated funds or entities to accurately assess the bidder's overall ownership interest in the target company. This aggregation can impact the bidder's ability to reach regulatory thresholds.

- Other portfolio companies: PE-backed bidders may have portfolio companies that hold shares in the target company. The attribution of these holdings to the bidder needs to be properly determined to assess potential conflicts of interest and to comply with disclosure requirements.
- Antitrust considerations: consolidating shareholdings may raise antitrust concerns, particularly if the bidder already has significant ownership in related industries or competitors.
- Shareholder agreements: shareholder agreements between the bidder and other shareholders have to be taken into account as they may have an impact on how the trigger percentage to launch the takeover bid is achieved.

7.4 Consideration

Consideration in most takeovers is paid in cash. Shares can also be used as consideration (eg, shares of the consolidating entity), although cash is far more common.

Mandatory takeover bids shall be submitted at an equitable price. This price amounts to the highest price paid by the bidder within the 12 months prior to the submission of the offer; alternatively, if no previous transactions have taken place, the equitable price shall not be lower than the exclusion price, which shall be determined by an independent expert.

7.5 Conditions in Takeovers

Mandatory takeover bids can only be conditional on the approval of the competition authorities and/or supervisory bodies, while voluntary bids can be subject to additional conditions, such as:

- approval of resolutions of the general shareholders' meeting of the listed company;
- acceptance by a certain minimum number of shareholders; or
- any other condition that complies with applicable law at the discretion of the CNMV.

A condition based on obtaining the required financing for the bid would not be admissible under Spanish law, as it would breach the principle of irrevocability of the bid and would be contrary to:

- the obligation of the bidder to ensure that it is able to cover any cash consideration in full; and
- the obligation of the bidder to provide a guarantee, or a cash deposit, to guarantee payment for shares that have been sold within the framework of the takeover bid.

Break-Up Fees

In the event of two competitive takeover bids, the listed company and the first offeror may agree a break-up fee by virtue of which the latter is compensated for the expenses incurred in preparing the bid. Break-up fees:

- cannot exceed 1% of the total amount of the bid;
- have to be approved by the board of directors of the listed company;
- must be supported by a favourable report from financial advisers; and
- must be detailed in the prospectus of the bid.

7.6 Acquiring Less Than 100%

Any bidder who has acquired at least a 90% stake of the share capital – with voting rights – of a listed company as a result of a takeover bid is entitled to require the remaining shareholders to sell their holding stake in the listed company at a fair price (ie, the consideration of the bid).

The prospectus must indicate the intention of the offeror to execute the squeeze-out right in the event of acquisition of 90% of the stake, which has to be executed within three months after the date of expiry of the acceptance period of the takeover bid.

Remaining shareholders also have a sell-out right, which must be executed under similar terms and conditions to the squeeze-out right.

Debt push-downs are typically used in public-to-private transactions (ie, PE that submits a takeover bid over listed companies with the aim of delisting them). There is no specific threshold to implement such structures, but it must be noted that shareholders' approval at the level of the target companies may be needed at the time of entering into the financing agreement and security instruments. In the most common debt push-down structure, a dividend or reserve distribution is financed by the target company for the shareholders, which in turn will cancel the initial financing. In any event, Spanish law restricting financial assistance will have to be considered when structuring a debt push-down.

7.7 Irrevocable Commitments

To ensure the success of a takeover bid, it is common to reach irrevocable commitments with significant shareholders prior to the issuance of the offer.

These commitments often include not only an irrevocable right to sell, but also a commitment to exercise voting rights in such a way as to facilitate the success of the bid (both at the shareholder level and, as far as legally possible, at the board of directors' level).

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentivisation of the management team is very common in PE transactions. As indicated previously, equity incentivisation aims to increase the value of the target company and its affiliates by providing an extraordinary incentive to the target's managers (independent from and additional to their employment or mercantile relationship with the company) in exchange for maximising the value of the company in a liquidity/exit event. The management will often retain equity between 5% and 10%.

Incentivisation is normally structured through MIPs, which might include:

- salary incentives, such as an extraordinary bonus (ratchet) linked to the ROI or the IRR of the PE fund and subject to the continuation of the management team;
- phantom shares or similar plans; and
- debt instruments, the interest on which is linked to the ROI or the IRR of the PE fund.

The rights and obligations of the management are regulated through shareholders' agreements, management incentive agreements (in the form of MIP general terms and conditions together with letters of endorsement by managers of the general conditions, which sometimes lay down special conditions) and/or executive director agreements.

8.2 Management Participation

PE investors hold preferred shares to retain decision-making control of the company, holding the majority of the voting rights of the company and/or certain veto rights over key decisions.

It is also quite common for the PE fund to finance the acquisition of the managers' equity (especially when the managers are not former shareholders of the company).

Management equity plans, which involve the investment of the management in the investment structure of the PE fund, are emerging as one of the most common incentive mechanisms in the PE environment. The investment is made indirectly at the same level as the PE fund, which typically takes place in a foreign jurisdiction, through several fully participating entities. It is common for all managers to invest in the same vehicle (ManCo), which is managed by the PE fund and holds the sweet equity.

8.3 Vesting/Leaver Provisions

Vesting provisions are very common in MIPs in Spain as they mitigate the risk of non-continuation of the key management team. They usually range between four and five years.

Accelerated vesting provisions are also very common, where in the event that the liquidity event occurs prior to vesting of 100% of the incentive, and provided that the beneficiary complies with all the terms and conditions set forth in the incentive agreement, the beneficiary would normally be entitled to receive 100% of the incentive amount at the time of the liquidity event.

MIPs also include certain "good-leaver" and "bad-leaver" provisions.

- Good-leaver provisions entitle the beneficiary to receive the total amount of the incentive linked to the liquidity event, or prior to the liquidity event, for certain specific and "reasonable" reasons agreed between the PE and the manager, including death, severe/permanent disability, dismissal by the company without cause or resignation by the manager for good cause.
- Bad-leaver provisions entitle the PE to early termination of the management incentive agreement, without paying the incentive to the beneficiary, and are the opposite of good-leaver scenarios.

8.4 Restrictions on Manager Shareholders

Restrictive covenants and obligations are usually regulated between the PE and the beneficiary in the shareholders' agreement, the employment/director's agreement and/or the MIP.

PE funds usually require the beneficiaries:

- to assume non-compete obligations and non-solicitation obligations, and to assume the obligations of exclusivity;
- to remain as managers for a certain period of time after the exit of the PE fund if the new investor offers them similar conditions; and
- in certain transactions, to include the R&W in the exit of the PE fund.

Non-disparagement covenants are not particularly common in Spain but can be agreed between the parties.

Restrictive covenants of managers, such as non-compete, non-solicitation and exclusivity provisions, are typically included in both equity plans and bonus/contractual plans, and a breach of such provisions usually has a negative effect on mangers' perceptions of the incentive.

It is important to analyse under the applicable law (particularly under labour legislation) and duly cover the remuneration of such obligations of the beneficiaries.

8.5 Minority Protection for Manager Shareholders

Manager shareholders are usually granted protection as regards exit/divestment of the PE fund and anti-dilution.

In this sense, in some cases manager shareholders have tag-along rights, so they are entitled to divest in the company at the same time as the PE investor, and the minimum valuation of its shareholding is required for the PE fund to exercise its usual drag-along rights.

Regarding anti-dilution protection, it is also common to guarantee that manager shareholders can maintain their percentage of sweet equity in the company during the investment period of the PE investors, or to grant them the financing required for subscription to additional shares. The anti-dilution provision typically includes a commitment from the PE to try, as far as possible, to seek non-dilutive external sources of funding. An exception to this principle is usually the urgent need for financing, which allows the fund to meet urgent treasury needs.

On the other hand, veto rights are generally reserved for PE investors through their preferred shares, either by having a direct veto right over certain decisions or by keeping control over the majority of the voting rights of the company (sometimes, there are no direct voting rights for sweet equity). However, some veto rights may also be granted to key shareholder managers.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

As a general rule, the management team is entrusted with the day-to-day activities of the company, while the PE has control over key matters at the level of both the shareholders and the board of directors.

This control is ensured in the usual shareholders' agreement by means of the following.

- Reserved matters in respect of which decisions will only be adopted with the vote of the PE fund (veto right), including, among others:
  - (a) at the shareholders' level – amendment to the by-laws, mergers, spin-offs, transformation or winding-up, distribution of dividends, share capital increase or decrease, approval of the annual accounts, appointment of the auditor of the annual accounts (if mandatory), disposal of essential assets, agreements with persons related to the other shareholders and the granting of convertible loans; and
  - (b) at the managing body level – the granting and revocation of powers of attorney, acquisition of assets or business exceeding a certain amount and/or outside the ordinary course of business, significant decisions over judicial proceedings, the obtaining of financing over a certain amount, formulation of the annual accounts, appointment of the auditor of the annual accounts (if voluntary), and approval of the remuneration policy of the company and the business plan.
- Reporting obligations to the PE fund.
- Drag-along rights.
- Purchase option.
- First offer or pre-emptive acquisition immediately after the lock-up period.
- Lock-up mechanisms.
- Non-competition, exclusivity and continuation covenants.

The relevant investment documentation typically includes the undertaking of the management to inform the PE fund on all matters materially affecting the business, assets, financial position, tax treatment and prospects of the relevant company, in addition to their periodical reporting obligations.

9.2 Shareholder Liability

The liability of the shareholders is, in principle, limited to the share capital contributed to the company. However, under certain exceptional circumstances, shareholders could be found personally liable through the application of the "corporate veil" doctrine – ie, when they have fraudulently benefited from the establishment of the limited liability company or group of companies.

The corporate veil doctrine was established by the Spanish Supreme Court in May 1984 with the aim of preventing the legal personality of a company from being used as a means or instrument of fraud, or for a fraudulent purpose. Its use is restricted and generally requires fraudulent use of the corporate personality and:

- control of several companies by the same person;
- related transactions between such companies; and
- no economic or legal justification for such transactions.

10. Exits

10.1 Types of Exit

The usual holding period for a PE fund before a divestment takes place ranges from four to six years, but it depends on many aspects such as the expected return or market momentum.

Auctions and bilateral sales have been the most common form of PE exit.

Dual- and triple-track processes require a significant investment of resources and time to materialise and are therefore only attractive to large-cap companies under specific circumstances (market appetite, potential acquirers, etc). However, if carried out effectively, dual- and triple-track processes increase the chances of an investor achieving a favourable divestment and maximising the value for existing market conditions.

The number of secondary buyouts increased significantly during the past few years, especially in 2022; in that year, secondary buyouts accounted for more than 40% of all deals, largely due to the high liquidity of funds resulting from the extensive and successful capital-raising processes seen in recent years. However, their prevalence declined throughout 2023, when almost 80% of all deals were pure investments.

10.2 Drag and Tag Rights

PE transactions usually include drag-along rights in favour of the PE investors. Such rights are included in the shareholders' agreement and aim to ensure partial or total divestment by the PE investors.

Thresholds vary among cases, but in PE transactions they apply to any co-investors, regardless of their nature and the percentage held.

If a co-investor is another PE entity, the lock-up period and exit by either investor is heavily negotiated.

Minority and manager shareholders are in some cases vested with tag-along rights governed by the relevant shareholders' agreement. The tag-

along rights of managers who are minority shareholders are typically triggered as a consequence of a sale of the PE fund of shares, which implies a change in the control of the company.

In the event that the PE investor is the minority shareholder, or when two PE investors are co-investors in the same target company, such PE shareholders will usually have both tag- and drag-along rights.

10.3 IPO

Although an IPO is still the preferred exit strategy for PE investors in large deals, this has become increasingly unusual, especially after the severe economic conditions brought on by the 2007–08 financial crisis and the COVID-19 pandemic, and also given today's economic uncertainty.

An IPO led by a PE fund has several features distinct from those of the traditional IPO of a non-PE-backed company. Some of the key characteristics are as follows.

- Valuation and pricing: the company's valuation at the time of the IPO is a critical factor. PE funds often work with investment banks to establish an initial share price that is attractive to both industrial and PE investors.
- Relationship with the company and management: PE funds often have an active role in the management and strategy of the invested company. However, after the IPO, their influence may diminish as the company becomes subject to increased scrutiny and governance by public shareholders.
- Partial or total sale: depending on the PE fund's strategies and market conditions, the IPO can involve a partial or total sale of the PE fund's stake in the company. Some PE funds may choose to retain a certain amount of shares to benefit from potential future increases in share price.

In summary, an IPO led by a PE fund can be an opportunity for both public investors and PE funds. It allows public investors to access a company with a proven track record and growth potential, while also enabling the PE fund to realise profits and redirect its capital to new investments.

Trends and Developments

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Deloitte Legal offers private equity (PE) services as part of its specialised services in M&A, for which it can call on the expertise of more than 100 professionals. The firm's team all have considerable experience in advising PE funds, covering all the milestones of a transaction. Deloitte Legal's multidisciplinary approach, specialisation by industry, and strong global network and presence in more than 150 countries enable it to offer a complete range of M&A transaction services, including expansion processes, alliances and divestitures. The firm deals with legal, tax and regulatory issues, among others, which can be crucial for the success or failure of an investment. Clients benefit from Deloitte Legal's extensive experience in M&A, its understanding of PE/VC markets and industries, and its close collaboration with colleagues in other disciplines within Deloitte's global organisation.

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Introduction

This report offers an overview of private equity (PE) activity in Spain for 2023 and the first half of 2024, along with the trends and legal considerations expected for the second half of 2024 in the context of the current extraordinary global situation.

Although transactional activity decreased in 2023 compared to other recent years, there were notable deals highlighting the strong track record of Spanish companies, both domestically and internationally. Similarly, PE funds have exercised more caution, although they have continued to analyse transactions and make investments or divestments when market conditions are favourable. A key trend is that transactions are being scrutinised more carefully, such that more time is required to close them.

An Overview of 2023

Historic record of investment by PE and venture capital (VC) in Spain

In 2022, the PE industry in Spain recorded the best figures in its history, despite the changing macroeconomic landscape and uncertainty arising from geopolitical conflicts according to the Spanish Venture Capital and Private Equity Association (SPAINCAP). The year witnessed extraordinary growth, driven by favourable investment opportunities, low interest rates and strong international investor interest.

FY 2023 was marked by geopolitical uncertainties, causing the Spanish VC and PE industry, like international markets, to remain cautious while awaiting more favourable interest rates and macroeconomic conditions for investment. This caution interrupted the positive investment trend, leading to a decline for the first time in recent years. This decrease in investment can be attributed to several factors that directly impacted the momentum of VC and PE activity, with three factors standing out in particular:

- increased financing costs caused by higher interest rates;
- uncertainty about the economy and the geopolitical environment, as well as price volatility; and
- diverging expectations of sellers and buyers regarding asset sale prices.

Nonetheless, despite challenges to global M&A activity, VC and PE investment in Spain achieved the fourth-highest figure on record in FY 2023.

2023 deal activity

SPAINCAP reported the following trends in Spain during FY 2023.

- Regarding sectors, the healthcare sector was the primary recipient of financing, receiving 31.3% of all funds invested. The industrial products and services and IT sectors ranked second and third, accounting for 24.1% and 8.1% of the total funds invested, respectively.
- By number of companies, the IT sector ranked first, accounting for 34.4% of all companies receiving investments in 2023, followed by healthcare, biotechnology/genetic engineering (both representing 10% of total), industrial products and services, and consumer goods (8% of the total each).
- During FY 2023, PE investment maintained its focus on sectors such as digitalisation, but also on sectors that are in the process of recovery, such as consumer products and industry.
- A total of 569 Spanish companies (90% of which are SMEs) received VC and PE funding in 2023. Regarding the number of investments in 2023, 844 transactions were completed in 569 companies, the third-best

figure on record. In total, 54% of investments were made in new companies (6% less than in 2022). Between 2018 and 2023, the VC and PE sector funded approximately 3,637 companies, approximately 90% of which are SMEs.

2024 Deal Activity and Expectations

FY 2023 was marked by geopolitical uncertainty, price volatility and rising financing costs and inflation. PE funds are now conducting more thorough due diligence to mitigate post-transaction risks. According to SPAINCAP, VC and PE activity in early 2024 mirrors that in 2023, influenced by high interest rates and geopolitical uncertainty. In Q1 2024, VC and PE investments totalled EUR1,191 million, a 42% decrease from Q1 2022, across 229 investments.

Despite this, experts highlight positive drivers such as the availability of dry powder for general partners, many companies being ready to launch, strong investor appetite, and international funds' commitment to Spain. Investment is expected to gradually rebound in the second half of 2024 following interest rate adjustments and economic stabilisation.

Regulatory Changes

New legal framework for leveraged mergers

On 29 June 2023, the Royal Decree-Law 5/2023 of 28 June was published in the Official State Gazette. This Royal Decree establishes a regulation on structural modifications (ie, transformation, merging, division and transfer of assets and liabilities, both domestic and cross-border). This law, effective from 29 July 2023, introduces certain modifications that impact the regime of certain structural changes, potentially affecting PE investments.

As a result of the amendment, the expert report requested for leveraged mergers subsequent to the leveraged acquisition of a target company no longer has to address the "existence of financial assistance", thus simplifying the process and avoiding controversies related to the evaluation of financial assistance in such transactions, where it is difficult for experts to determine whether any such assistance is fair and equitable.

The removal of this requirement has several benefits for PE funds engaging in leveraged mergers in Spain:

- faster execution – streamlines the transaction process, allowing quicker completion of leveraged mergers;
- reduced costs – eliminates the need for additional evaluations, lowering transaction costs and improving ROI; and
- enhanced deal flexibility – provides greater flexibility in structuring mergers, aligning with investment strategies and financing requirements.

Amendment to the investments made by non-EU/European Free Trade Association (EFTA) investors

On 5 July 2023, the Official State Gazette published Royal Decree 571/2023, dated 4 July, concerning foreign investments. This Royal Decree outlines the control regime for foreign investments in Spain and Spanish investments abroad and came into effect on 1 September 2023.

The Royal Decree introduced changes to the reporting obligations for foreign investments in Spain and Spanish investments abroad, including divestments. Generally, investments acquiring less than 10% of voting rights or capital in the

target entity are exempt from reporting. However, certain types of operations, which were not covered by the previous decree, are required to be declared. These include acquisitions of shares in closed-end investment schemes, contributions to Spanish companies' net equity without increasing the share capital, financing provided to subsidiaries from the same group exceeding EUR1 million and reinvestment of profits when the investor holds at least 10% of the Spanish company's share capital.

The obligation to report investments in certain entities such as joint accounts (*inversiones en cuentas en participación*), temporary unions of companies, foundations, economic interest groupings and communities of property remains, but the reporting thresholds have been reduced to EUR1 million, provided the investor's share constitutes at least 10% of the total value.

Additionally, the decree clarifies that foreign investments in Spain witnessed by a Spanish notary will be reported by the notary, relieving non-resident holders from reporting.

Furthermore, the decree updates the pre-declaration regime for investments involving jurisdictions classified as noncooperative (formerly tax havens). Pre-communication remains necessary but now applies only to cases where the acquired stake exceeds 10% or, concerning real estate, if the investment surpasses EUR500,000 (for investments in Spain) or EUR300,000 (for investments by Spanish residents abroad). Such investments also require a subsequent communication in all cases, without the use of thresholds.

As explained above, the Royal Decree also focuses on the suspension of the liberalisation regime introduced by Article 7 bis of Law 19/2003 during the COVID-19 pandemic, affecting investments in sectors concerning public order, security and public health.

- Notably, the Royal Decree allows interested parties to seek voluntary consultations with the Directorate General of International Trade and Investments to determine the need for authorisation, streamlining the process.
- Furthermore, the Royal Decree clarifies control obligations for investments made through specific vehicles, such as collective investment institutions, pension funds or similar structures. It also considers multiple foreign investments within a two-year period as a single investment for authorisation purposes, simplifying the approval process.
- The Royal Decree outlines detailed procedures for obtaining authorisation, including shortened resolution periods, reducing the time required for investors to receive a response. Additionally, it removes the simplified procedure for investments below EUR5 million, streamlining the requirements for larger investments.
- The Royal Decree also includes exemptions from prior authorisation for certain subsectors and "transitory investments", allowing for a more flexible approach in specific cases. It identifies the sectors subject to suspension and provides further clarity on entities that require authorisation due to their inherent nature.

In conclusion, the Royal Decree aims to create a more efficient and transparent framework for foreign investments, promoting economic growth while ensuring that investments in sensitive sectors adhere to national interests and security concerns.

EU Foreign Subsidies Regulations

On 23 December 2022, Regulation (EU) 2022/2560 on foreign subsidies that distort the internal market (FSR) was published, empowering the European Commission to investigate subsidies from third countries to EU-operating companies that may affect market competition.

FSR took effect on 12 January 2023 and has been applicable since 12 July 2023, with a gradual implementation. As of 12 October 2023, mandatory notification and authorisation for certain transactions, including mergers and public procurement bids meeting specific thresholds, were introduced. This includes transactions where the acquired company, merging party or joint venture generates an EU-wide turnover of at least EUR500 million, and where the foreign financial contribution exceeds EUR50 million. PE firms must notify the European Commission about received foreign subsidies.

The regulation is relevant for various economic activities and requires firms to conduct thorough due diligence on foreign subsidies to comply and avoid transaction delays.

M&A Trends

New trends have emerged (or previous trends have been strengthened), as analysed in the subsequent sections, due to the increased cost of financing, geopolitical uncertainty (mainly caused by the Ukraine-Russia and Gaza-Israel conflicts) and inflation.

Bilateral sale processes

In 2021, more than half of all PE transactions were in the form of auctions with expedited deadlines, mainly due to the pandemic; however, this trend changed dramatically in 2022 because of the unstable macroeconomic situation, which continued into 2023.

In this sense, during 2023, PE investors preferred a bilateral process that may grant more certainty instead of PE transactions run as auctions with multiple prospective bidders; nevertheless, the number of PE transactions run as auctions increased slightly, returning to more typical figures.

Conditions precedent

The most common regulatory condition precedents of PE deals are the need for regulatory approvals (particularly antitrust, foreign direct investment (FDI) and, more recently, foreign subsidies) that shall be completed prior to the closing date.

In PE transactions, either due to the PE investor's profile or because the FDI involves a target company operating in a strategic sector, a preliminary analysis (whether there is a requirement to notify or obtain prior approval from the relevant regulatory authority in Spain in relation to a particular potential investment) is usually needed for most deals involving international parties. In 2023, many deals required a preliminary analysis of the need for regulatory approvals but, based on the conclusion of such analysis, most PE transactions ultimately did not need to include a condition precedent in the sale and purchase agreement for that purpose.

In Europe, sectors such as energy, technology and infrastructure are highly active in the current M&A and PE market and are usually considered areas of particular concern for the governments.

Locked-box

In recent years, the use of the locked-box mechanism has significantly increased, and this trend was consolidated again in 2023; the locked-box mechanism was the most widely used pricing

mechanism in both sell-side and buy-side PE transactions.

With the locked-box mechanism, financial risk is transferred to the purchaser on the locked-box date, and because the purchaser can benefit from the profits generated from that date – while the price is paid at closing – the seller usually tries to seek compensation, mainly by using equity tickers or ticking fees.

Such equity tickers or ticking fees are commonly structured as a fixed daily amount from the locked-box date or signing date until the closing date, or as a fixed daily rate (usually between 5% and 8% per annum).

Likewise, a mechanism combining the locked-box and completion accounts mechanisms is also commonly used (mostly in more complex transactions and those of higher value).

Increasingenvironmental, social, and governance (ESG) influence

The incorporation of ESG criteria into the valuation of PE transactions is not yet particularly relevant, and funds recognise that they have not been able to use ESG as a lever for EBITDA optimisation in their companies; however, they recognise the importance of ESG, especially for improving multiples. In addition to being a key factor for improving a company's valuation multiple, a robust ESG strategy should be able to improve the company's bottom line.

PE investors are compelled to reshape their strategies due to increasing demands related to ESG concerns. The significant impact of ESG on reputations has prompted acquirers to prioritise enhancing their ESG credentials, making it a decisive factor in M&A decision-making. As a result, ESG parameters are increasingly being evaluated in every deal to mitigate risks and drive sustainable value creation; consequently, specific ESG due diligences have seen an uptick compared to those carried out in 2022.

From a legal point of view, ESG has significantly impacted M&A and PE transactions in several areas:

- due diligence – as indicated above, specific ESG due diligences have seen an uptick;
- target – buyers are showing growing interest in green transactions, targeting sustainable and socially responsible assets in areas like renewable energies, energy efficiency, clean transport and responsible waste management. Green-finance transactions, including sustainability-linked bonds and social bonds, have also gained prominence; and
- transaction documents – the findings under an ESG due diligence are reinforced by including specific representations and warranties, as well as seller commitments, related to ESG matters in the transaction documents.

Market participants are now obligated to disclose ESG information under the EU's Disclosure Regulation and Taxonomy Regulation, guided by regulatory technical standards.

SWEDEN

Law and Practice

Contributed by:
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Gernandt & Danielsson has an established reputation as one of the leading law firms in Sweden, advising private equity funds and their portfolio holdings on the full range of private equity-related matters including investments, acquisitions and divestments as well as fund formation. Gernandt & Danielsson has a strong international practice and close working relationships with leading law firms in all Scandinavian jurisdictions, elsewhere in Europe and around the world. The firm's private equity practice includes private and public M&A, capital markets, corporate and commercial, banking and finance, regulatory, fund formation and restructuring. The team, comprising approximately 90 lawyers, includes a strong bench of leading individuals, which are highly specialised in leading complex private equity mandates.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

M&A and private equity deal activity has continued to increase from the low levels seen since 2022 due to, among other things, increased market certainties and lower financing costs.

In the current politically and economically complex environment, a continued trend during 2024 has been that deals tend to take longer than usual to conclude. Increased expenses related to financing and the difficulty of pricing targets in abnormal market conditions have often led to increased gaps in valuation between sellers and buyers. As a result of this, there is a tendency for purchase price mechanics to become more diversified, and elements such as re-investments, deferred payments and earn-outs have started to become part of negotiations to bridge valuation gaps.

Whilst the generally lower valuation of public companies in 2022 resulted in increased public M&A activity, 2023 and the first half of 2024 only saw a few public offers. The IPO exit conditions remain less favourable, and as a consequence of this, IPO activity in Sweden remained significantly lower during 2023 and the first half of 2024 compared to recent years. Only a very limited number of SPACs have come to the markets, with no larger SPAC IPOs since the end of 2021.

1.2 Market Activity and Impact of Macro-Economic Factors

Industries that have been specifically targeted in private equity deals during 2024 include SaaS, information technology and cyber security, infrastructure and healthcare.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

International Sanctions

Sweden does not have its own nationally resolved sanctions. Instead, EU and UN sanctions are implemented and enforced. Non-compliance is penalised and can lead to both corporate and individual liability. In recent years, the tightening of sanctions – particularly in response to geopolitical events such as Russia's invasion of Ukraine – has increased the regulatory burden on private equity firms. This includes increased screening with respect to counterparties and investments to avoid links to sanctioned entities, individuals, goods and services.

Although private equity firms are not legally mandated to maintain comprehensive sanctions screening programmes, they must still comply with all applicable sanctions regulations. Therefore, it is advisable for private equity firms to design international procedures to screen out investments linked to sanctioned entities, individuals, goods and services. Prominent institutional investors frequently request documentation of such internal procedures and may even seek legal opinions regarding specific investors or investments from a sanctions compliance perspective.

Sanctions have effectively ended new direct investments in Russia. Additionally, private equity players face significant challenges in divesting from Russian holdings, including difficulties in processing payments, potential authorisations from regulatory authorities in Sweden and abroad, and complex assessments at the intersection of EU, US and UK sanction regimes. The further increased sanctions against Russia during the past year have exacerbated these

challenges by tightening financial restrictions, increasing the responsibility for re-exports, cracking down on circumvention efforts, and expanding the list of sanctioned entities, individuals, goods, and services. Consequently, the regulatory burden on private equity firms has continued to increase with respect to international sanctions in general, and with respect to Russia in particular.

Security-Sensitive Activities

The Protective Security Act (Security Act) imposes obligations on entities that to any extent undertake certain security-sensitive activities (eg, operation of airports, information systems for electronic communication and provision of payment services).

From a private equity perspective, the main implication is that the target entity is obliged to perform a special security assessment and an assessment of suitability as well as consult the supervisory authority ahead of any sale, co-operation or other activity lending a party access to security-sensitive information or activities.

Any transfer of shares pertaining to, in any part, security-sensitive activities that has not been approved by or not subjected to consultation with the supervisory authority may be declared legally invalid by the authority.

Foreign Direct Investments

Sweden has a newly established regime on foreign direct investments concerning Swedish undertakings involved in vital societal functions and critical infrastructure (the Swedish regime is broad). An investor must notify the competent authority before carrying out an investment in such undertakings. Save for certain exceptions, the target generally has an unsanctionable obligation to inform an investor that its activities are subject to a filing obligation.

The threshold for notification is set at direct and indirect investments that result in the acquisition of voting rights equal to or exceeding 10, 20, 30, 50, 65, or 90 percent in the relevant undertaking. Notification is also required if the investor otherwise acquires influence over the management – eg, the right to appoint one board member. Greenfield investments are caught by the legislation. The supervisory authority has the discretionary power to call in any transaction that is not triggered by the notification obligation.

The notification obligation applies to both Swedish and foreign investors, and exists in parallel with the Security Act. However, the supervisory authority can only set conditions for, or ultimately prohibit, an investment made directly or indirectly by non-EU investors. Violating the rules can result in a penalty fee of up to SEK100 million and invalidation of investments made in breach of the regime.

The review process consists of two phases: (i) a mandatory review (Phase I), and (ii) an in-depth review (Phase II), should the supervisory authority decide to further scrutinise the investment. While the supervisory authority has carried out a number of so-called Phase II reviews and imposed remedies, no deals have been blocked so far.

From a private equity perspective, the regime on foreign direct investments requires the consideration of additional factors during the preparation, negotiation and execution of transactions. This includes necessary due diligence measures to ensure compliance with the rules, as well as a clear allocation of responsibility and risk associ-

ated with obtaining any necessary approvals and managing the transaction timeline to this effect.

ESG and Sustainability

The main ESG and sustainability-related disclosure requirements derive from Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (SFDR), Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (Taxonomy Regulation) and Directive (EU) 2022/2464 as regards corporate sustainability reporting (CSRD).

With respect to upcoming developments, the European Parliament and the Council of the European Union recently adopted the Directive on corporate sustainability due diligence (2022/0051(COD)) (CS3D), setting out, inter alia, certain due diligence requirements regarding human rights and environmental standards in their supply chains.

Sustainability-related disclosures

The reporting requirements under the SFDR are only applicable to private equity entities qualifying as a "financial market participant" under the SFDR – eg, an investment firm that provides portfolio management and an alternative investment fund manager. The content, methodology and presentation of the information that is to be disclosed under the SFDR are set out in the regulatory technical standard to the SFDR – the Delegated Regulation (EU) 2022/1288. The extent, content and frequency of the reporting obligations partly depend on undertakings made by financial market participants with respect to SFDR disclosures, and partly depend on the relevant "financial product" – eg, a managed portfolio or an alternative investment fund.

Corporate sustainability reporting and the Taxonomy Regulation

The CSRD has been implemented in Swedish law and the relevant provisions entered into force on 1 July 2024. The reporting obligations under the CSRD will be applicable in tranches starting in the accounting year 2024 (with reporting in 2025) and onwards, depending on the company in-scope. The reporting shall be made in accordance with, inter alia, the Delegated Regulation (EU) 2023/2772 setting out the European sustainability reporting standards. Alternative investment funds that are incorporated as a company in Sweden – eg, a limited liability company, are excluded from the scope of the Swedish implementation of the CSRD.

Government Initiative to Enhance the Competitiveness of the Swedish Fund Market

In December 2023, the Swedish government resolved to establish a committee tasked with analysing and proposing measures to enhance the competitiveness of the Swedish fund market.

The government's directive to the committee emphasises that current Swedish fund legislation provides a comparatively limited range of fund structures relative to other countries. The committee will examine fund structuring on the Swedish market, potentially introducing legal frameworks for funds with variable share capital and contractual AIFs.

The committee is expected to present its proposals by April 2025.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

On a general level, there is a high degree of contractual freedom regarding acquisitions and sales of private limited liability companies in Sweden. Mandatory filings are, as a general rule, limited unless the business conducted by the target or either of the parties is regulated. Regarding acquisitions of publicly traded companies, special regulations, including the Takeover Rules for Nasdaq Stockholm and Nordic Growth Market, apply.

Merger Control Filings

The main regulatory gateway that currently arises in Sweden in private equity transactions is merger control filings. The Swedish Competition Authority (SCA) is well experienced in private equity deals and is able to swiftly process and approve straightforward cases. There has not yet been any indication that the SCA intends to follow the recently announced hawkish approach towards private equity deals to be taken by US antitrust regulators. On the contrary, while the SCA's statutory review period is one month, recent experience indicates that the SCA may issue clearances within ten days, without any requirement of pre-notification contacts. Moreover, in more complex deals, the SCA has been able to conduct its in-depth investigation without jeopardising the deal timetable (see, for example, Accent, Tempcon, or Lincargo).

A merger filing with the SCA must be submitted by the acquirer if (i) the combined turnover in Sweden of all the parties exceeds SEK1 billion, and (ii) each of at least two of the parties involved generates turnover in Sweden above SEK200 million. Similar to many other jurisdictions, the SCA has the power to investigate deals below the mandatory threshold of SEK200 million. While not unusual in industrial deals with high shares, this rarely happens in private equity-backed deals. The substantive test applied by the SCA is identical to that of the EU Commission, meaning that the SCA will oppose (or require remedies) if a transaction is liable to significantly impede effective competition.

Foreign Direct Investments and the Security Act

Please refer to **2.1 Impact of Legal Developments on Funds and Transactions** regarding notification requirements under the Security Act and Foreign Direct Investments.

Foreign Subsidy Regulation (FSR)

The EU FSR regime is generally relevant when the target has EUR500 million or more in EU turnover as private equity funds typically meet the other thresholds, in particular private equity funds linked to sovereign wealth funds.

Deals involving sovereign wealth investors tend to be subject to more scrutiny as entities with links to non-EU governments are a factor the Swedish supervisory authority of foreign direct investments has to consider when reviewing transactions. However, while the Swedish supervisory authority has carried out a number of so-called Phase II reviews (see **2.1 Impact of Legal Developments on Funds and Transactions**) and imposed remedies, no deals have been blocked so far.

The AIFM Act

The Swedish Alternative Investment Fund Managers Act (AIFM Act) implements Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (AIFMD) into Swedish law. The AIFM Act sets out the central

provisions on authorisation, ongoing management and disclosure obligations for managers of alternative investment funds (AIFMs) with regard to their marketing and management of alternative investment funds (AIFs) within the EU. The Swedish Financial Supervisory Authority (SFSA) is the supervisory authority under the AIFM Act.

As a main rule, no Swedish AIFM may manage an AIF unless authorised by the SFSA under the AIFM Act. However, Swedish sub-threshold AIFMs may instead apply for registration with the SFSA.

The AIFM Act also contains provisions on marketing of EEA-based and non-EEA based AIFs by Swedish and foreign AIFMs to professional and non-professional investors in Sweden and abroad. The Directive on Cross-Border Distribution of Funds (2019/1160/EU) is implemented into Swedish law.

The AIFM Act further includes an obligation to notify the SFSA of certain acquisitions and disposals. For example, if an AIF has acquired 50% or more of the voting rights of a non-listed company or 30% or more of the voting rights of a listed company (control), the AIFM will be subject to more extensive notification obligations. Following such acquisition, the AIFM must, inter alia, provide the SFSA, the target company and its shareholders with information on the identity of the AIFM and the AIFM's policy for preventing and managing conflicts of interest. As regards acquisitions of control of non-listed companies, the AIFM is subject to additional disclosure obligations. It shall, inter alia, provide the SFSA, the target company and its shareholders with information on the chain of ownership in the AIF. The AIFM must also provide the SFSA and investors in the AIF with information on the financing of the acquisition.

Furthermore, an AIFM managing an AIF that has acquired control over a non-listed company or listed company may not facilitate, support or instruct certain distributions, capital reductions, share redemptions and/or acquisitions of own shares by the target company for a period of two years following the acquisition of control.

Finally, the AIFM Act contains extensive general information obligations for AIFMs. For example, an AIFM shall notify the SFSA prior to implementing any material changes in its operations or organisation. Each such change, which includes, inter alia, the appointment of new board members or a new CEO of the AIFM, changes in the ownership of the AIFM and changes in the use of leverage, must be subject to pre-approval by the SFSA.

This is only a selection of provisions in the AIFM Act most relevant for private equity funds. The AIFM Act (including supplementing provisions) has several other provisions affecting private equity funds.

AIFMD II

The final text of the amendments to the AIFMD – known as "AIFMD II" – was published in the Official Journal of the European Union on 26 March 2024, and entered into effect on 15 April 2024. EU member states are granted a period of two years from the date of publication to incorporate the rules into their national legislation. Consequently, AIFMD II will be applicable starting 16 April 2026, although certain provisions will be subject to a transitional period.

AIFMD II includes enhanced regulatory requirements for alternative investment fund managers (AIFMs), including new rules for loan origination, improved liquidity management, expanded reporting obligations, stricter investor protection

measures, and updates to sustainable finance practices. Additionally, the amendments address delegation arrangements, marketing restrictions, and rules regarding cross-border activities.

A proposal for the Swedish transposition of AIFMD II is likely to be presented in 2025.

4. Due Diligence

4.1 General Information

A comprehensive due diligence is typically carried out by private equity buyers, covering legal, financial, tax and various commercial matters, depending on the nature of the target's business. The scope is also to a large extent based on the demands from providers of representation and warranty insurance (RWI) to provide the necessary coverage (as RWI is customary in Swedish private equity transactions). The due diligence is typically carried out in close co-operation between legal, financial and tax professional advisers, relevant experts, and representatives of the private equity buyer's deal team.

The legal due diligence is typically reported on in an exceptions-only format, which focuses on identified red flag issues to be addressed in connection with the transaction, and typically contains limited descriptive information. The focus areas of the due diligence are decided upon based on the nature of the target's business and the demands from providers of RWI to provide the necessary coverage. Typical focus areas for the legal due diligence include:

- a review of the regulatory framework applicable to the business;
- a review of the contractual framework for the business;
- a review of the terms of key customer and supply contracts, as well as any joint venture, co-operation and partnership agreements (and other agreements that are material to the business);
- a review of terms for management and key employees, including addressing potential retention risks;
- past, ongoing and upcoming or expected litigation and investigations by authorities; and
- identifying other matters that are or could become impediments to the transaction and need to be handled through transaction structure, pre-signing, pre-closing or in the integration phase.

Furthermore, it is common for private equity buyers to request specific compliance, insurance and ESG due diligence. In recent years, private equity funds have increased their focus on compliance matters, which has led to areas such as compliance, anti-bribery, anti-corruption, information security, processing of personal data and related matters becoming focus points of due diligence.

In transactions that are financed with external loans, the due diligence reports are typically shared with the lending banks on a reliance basis.

4.2 Vendor Due Diligence

In sales that are structured as auction processes, a vendor due diligence (VDD) covering financial, tax and legal issues is common. It is also becoming increasingly common for the seller to provide a legal guidance report. The purpose of the VDD, apart from expediting the auction process by limiting the work prospective bidders need to do in order to understand the target's business, is to ensure that all bidders have access to the

same information in order to maximise the value and comparability of the bids.

If the VDD report is offered with reliance for the final bidder, it is common for a private equity buyer to instruct its advisers to perform a limited top-up due diligence of the VDD report, rather than a full-scope due diligence. A top-up due diligence would typically be limited to confirming and analysing issues identified in the VDD report and performing additional due diligence on identified gaps in the VDD report or areas which are of specific interest to the buyer. The VDD report would also typically speed up the RWI underwriting process.

5. Structure of Transactions

5.1 Structure of the Acquisition

A private equity fund's acquisition of a Swedish company is typically made under a private sale and purchase agreement. Share sales are most common and give the parties more flexibility than a business or asset transfer, where, for example, union consultation and consents from creditors or counterparties may be required.

The differences between the terms of an acquisition made in a bilaterally negotiated transaction and an auction sale have been limited in Sweden in recent years, and depend more on the bargaining power of the respective parties than on the fact that the sale is a bilateral or auction process. A seller in an auction sale will typically have stronger bargaining power than a seller in a bilateral sale, depending on the number of bidders and level of interest in the auction.

In line with the above, the terms in an auction sale with a private equity seller would typically include high deal certainty, with any conditionality usually restricted to merger clearance and other strictly required regulatory approvals (as applicable). Almost all private equity-backed trade sales will require the buyer to take out representation and warranty insurance, and will only offer representations and warranties to the extent that the buyer is able to insure them. To the extent that no representation and warranty insurance is taken out, or coverage of a certain warranty is not granted by the insurer, a private equity seller will typically have a very strict approach to the scope and limitations of representations and warranties.

A selling private equity fund is usually sensitive to all types of post-closing liability and will try to limit the same to the furthest extent possible. This is interlinked with the fact that any post-closing liability may require the private equity fund to set aside funds for claims during the claim period, which could have been returned to investors instead.

5.2 Structure of the Buyer

A private equity buyer would typically be structured by way of the private equity fund establishing a special purpose acquisition vehicle, which would consist of a multi-tier structure of three or more Swedish limited liability companies (*aktiebolag*). Foreign holding entities between the fund and the Swedish holding companies are not uncommon.

Typically, the structure will consist of a topco, where the equity will be held by the buying private equity fund, and by re-investing sellers and management as individuals, via wholly owned companies or via a jointly owned management company (manco). The topco owns the midco (which would take up any junior debt financing), which in turn owns the bidco. The bidco is the

acquiring entity, and also the one taking up any senior debt financing.

The only transaction documentation the fund will typically be a party to is, if required, an equity commitment letter, as further outlined in **5.3 Funding Structure of Private Equity Transactions**.

5.3 Funding Structure of Private Equity Transactions

Swedish private equity deals are typically financed by a mixture of equity funding provided by the private equity fund, using commitments from its underlying investors, and third-party debt from banks, credit funds and other alternative lenders. The ratios of senior debt and equity vary from case to case, depending, for example, on deal size, market conditions and the sector where the investment is made.

Historically, bank loans have been by far the most common financing method for Nordic private equity transactions, but credit funds and other alternative lenders have quickly gained prominence in recent years, for example due to more flexible funding terms and the ability to invest in junior debt. This trend has been further cemented due to the exacerbated market conditions seen since the second half of 2022, leading to a scarcity of traditional funding sources, further pivoting the market in favour of both domestic and overseas alternative lenders.

Bond debt became an increasingly popular funding source during 2020 and 2021, but the Swedish bond market effectively came to a near halt during the second half of 2022 due to market uncertainties and the increasing cost of bond debt, combined with spill-over effects of the downward pressure on real property bonds. However, bonds have begun regaining popularity with the Swedish bond market re-opening in the first half of 2024. The rapidly growing direct lending market where, for example, credit funds are increasingly active is especially interesting for certain borrowers and certain sectors where there are funding gaps.

If the private equity buyer's acquisition structure includes a special purpose acquisition vehicle as the buying entity, the fund will (upon the seller's request) typically issue an equity commitment letter addressed to the special purpose acquisition vehicle and the seller, committing to provide the buying entity with funds to pay amounts due under the transaction agreement. Lenders also frequently provide comfort over the debt-funded portion of the purchase price by committing certain debt funds, signing off on as many condition precedents as possible in advance.

Private equity deals in Sweden are generally control investments. The investment mandates of the funds typically require the funds to hold majority stakes. However, there has been a recent increase in minority investments as set out under **5.4 Multiple Investors**, and certain private equity funds, including venture capital funds, regularly make minority investments.

5.4 Multiple Investors

In larger transactions, it sometimes happens that private equity buyers form consortiums. Albeit rare, such consortiums can include corporate investors. The size of the fundraising rounds, and the size of the investments made, have been growing steadily, and minority investments are getting more common. There are also buyout funds that have started to raise capital specifically intended for minority investments.

The management team is regularly offered to own a small portion of ordinary equity, but rep-

resents only an insignificant portion of the equity funding.

It is common for limited partners to make direct investments alongside the general partner. These investments are often passive. This kind of equity syndication is often done after the transaction has been signed but prior to the transaction being funded and closed.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Consideration Mechanisms

As outlined in **1.1 Private Equity Transactions and M&A Deals in General**, the difficulty of pricing targets in abnormal market conditions has led to purchase price mechanics again becoming more diversified. However, in Sweden the most commonly used forms of consideration structures are still locked-box and closing accounts mechanisms. The locked-box structure is most common in Swedish private equity transactions and especially favoured by sponsor sellers. Closing accounts and other true-up mechanisms are often applied in complex transactions involving a spin-off or carve-out component, where the business does not have a standalone balance sheet and/or long-term historic financials or the working capital levels of the target are difficult to predict.

Vendor Participation

Other than for management reinvestment, as outlined in **8.1 Equity Incentivisation and Ownership**, vendor participation is not, or has at least not during the last couple of good years been, a common feature in Swedish private equity transactions. On occasion, vendor participation has been used to bridge valuation gaps where a buyer has difficulty raising sufficient external financing.

Earn-Outs

Earn-outs are more frequently used in times of market uncertainty and are common when private equity funds acquire a business that is founder-owned. With respect to acquisitions of recently founded growth companies, earn-out components are leveraged by private equity buyers to ensure that the consideration for the business is in line with the expected financial performance. Roll-over structures are common when the founders or management shall remain involved in the acquired company.

Level of Protection Offered by Private Equity Sellers and Buyers

The protection offered by a private equity seller in relation to consideration mechanisms is generally based on warranties and covenants during the period between signing (or, in a locked-box transaction, the locked-box date) and closing, and is similar to the protection offered by a corporate seller. In locked-box mechanisms, the additional customary protection consists of an undertaking structured as an indemnity to compensate the buyer for leakage.

The protection offered by a private equity buyer in relation to consideration mechanisms is typically limited. Escrow solutions are not the norm in Swedish transactions, and depend on the bargaining power of the parties.

Ring-fencing protection regarding earn-out mechanisms is customary. Private equity buyers rarely accept limitations on the conduct of the target's business operations, but may instead sometimes be willing to agree to adjust the earn-out calculation to correspond to what it would

have been if the breach of the ring-fencing provision had not occurred.

6.2 Locked-Box Consideration Structures

As discussed in **6.1 Types of Consideration Mechanisms**, locked-box is the most common consideration mechanism in Swedish private equity transactions. In a Swedish locked-box transaction the purchase price generally includes an interest component where interest accrues on the equity value.

6.3 Dispute Resolution for Consideration Structures

In a locked-box deal the dispute resolution mechanism for the entire agreement, which is typically arbitration under the rules of the Stockholm Chamber of Commerce, would also apply to disputes regarding the locked-box consideration. In a completion accounts deal it is common to have a specific expert determination procedure for disagreements regarding the completion accounts consideration.

6.4 Conditionality in Acquisition Documentation

Deal certainty is fundamental for private equity sellers and Swedish private equity transactions tend to have minimal conditionality, usually limited to mandatory filing obligations such as merger clearance and FDI. Material adverse change clauses are not common. Covenant undertakings from the seller to try to obtain third-party consents from key contractual counterparties are common, but only on a covenant bases – ie, not on a conditionality basis.

6.5 "Hell or High Water" Undertakings

A private equity seller will, in accordance with the principle of minimising transaction risk, expect a buyer to assume extensive merger control obligations. A private equity buyer is typically willing to accept fairly extensive merger control obligations in a competitive auction provided that the merger filing analysis does not identify material overlaps. However, it is important to limit obligations to the buying entity, and as a general rule not accept obligations in relation to other portfolio companies, or standstill provisions, which could both constitute breaches of the fund's fiduciary obligations towards its investors.

Private equity funds are typically reluctant to accept hell or high water undertakings with respect to EU FSR as the regime is relatively new and still unpredictable (please refer to **3.1 Primary Regulators and Regulatory Issues**). However, sellers tend to get comfortable if the private equity funds' counsel confirm that they have not identified any "most likely distortive" subsidies within the meaning of the EU FSR.

6.6 Break Fees

Break fees, including reverse break fees, are rare on the Swedish market in general, including in private equity transactions. In competitive processes, they are, however, more common if there is a merger filing condition.

6.7 Termination Rights in Acquisition Documentation

As deal certainty is a central component in most private equity transactions, termination rights are typically limited and heavily resisted by both parties. The acquisition agreement can typically only be terminated if conditions precedent are unfulfilled at the long-stop date commonly falling 6 months after signing, or if a party does not fulfil its obligations at closing, in which case closing would typically be rescheduled once before the agreement would be terminated.

6.8 Allocation of Risk

Sellers in private equity transactions typically want to achieve a clean exit, as any residual liability would count against the return they can distribute to their investors. Private equity sellers therefore strive to limit residual liability in the transaction documentation.

In Sweden, the buyer's knowledge (including information in the data room) will normally be considered as disclosed against the warranties, which means that any specific findings need to be priced or negotiated as indemnities. However, as warranties are typically given both at signing and closing, the risk for the target remains with the seller until closing. This is one of several contributing factors to RWI being the norm in Swedish private equity transactions, as outlined in **6.9 Warranty and Indemnity Protection**.

The main limitations on liability for the seller regarding the seller's warranties are outlined in **6.9 Warranty and Indemnity Protection**. Other limitations on the seller's liability include, as a rule:

- several liability for the sellers (as opposed to several and joint);
- a cap corresponding to each seller's portion of the purchase price;
- provisions regarding notification of claims; and
- provisions regarding conduct of third-party claims.

6.9 Warranty and Indemnity Protection

General

When RWI is in place, it is common for private equity (and other) sellers to agree to a wider scope of warranties than would otherwise be the case, provided that the warranties can be insured based on the buyer's due diligence. Correct scoping of the due diligence is very important in ensuring satisfactory coverage. In insured transactions, the scope of the warranties is a matter primarily between the purchaser and the insurer, as private equity sellers typically only assume liability for fundamental warranties in excess of the RWI limit.

In the Swedish market, buy-side RWI is by far the most common, as sell-side RWI is both more expensive and offers less coverage. On the Swedish market it is uncommon for RWI to be unavailable due to timing or other process constraints, as brokers and underwriters have developed the underwriting process and product offering to offer more flexibility.

In a deal where RWI is for any reason not taken out, a private equity seller would give fundamental warranties, but would typically resist giving business warranties. As in any other uninsured transaction, the scope of the warranties is primarily a commercial matter and would depend highly on the bargaining power of the parties.

Treatment of Private Equity Sellers compared to Management Sellers

Private equity sellers and management sellers receive, as a starting point, equal treatment under the acquisition documentation. The background is the applicable shareholders' agreement, which as a rule does require equal treatment (with certain exceptions).

Limitation of Liability

The limitations on the seller's liability for warranties are:

- de minimis – 0.1–0.3% of the purchase price;
- basket – 1–3% of the purchase price;
- cap – 10–50% of the purchase price (in uninsured transactions, the cap is closer to

10% for a private equity seller, and closer to 30–50% for founder or corporate sellers); and
- time limitations – 12–36 months' general limitation period, with 24 months being the most common, and with extended limitation periods for fundamental warranties and tax warranties.

As set out in **6.8 Allocation of Risk**, the buyer's knowledge (including information in the data room) will normally be considered as disclosed against the warranties, which means that any specific findings need to be priced or negotiated as indemnities.

6.10 Other Protections in Acquisition Documentation

Protection Offered by the Seller

The seller typically offers (i) warranties, (ii) covenants regarding conduct of business between signing and closing, and (iii) sometimes certain other restrictive covenants in the acquisition agreement. It is uncommon for private equity sellers to grant indemnities, as they prevent a clean exit. Tax covenants are not seen on the Swedish market (where tax warranties are deemed sufficient), but are sometimes requested in transactions where there are UK or US elements.

Typical warranty protection and RWI are outlined in **6.9 Warranty and Indemnity Protection**. It is not common to have an escrow, reverse equity commitment letter, or other retention arrangement in place to secure the obligations of a private equity seller.

Covenants Regarding Conduct of Business

If there is a gap between signing and closing, a private equity seller usually assumes customary covenants regarding the target's business being conducted in the ordinary course of business between signing and closing.

Post-closing Covenants

As opposed to a corporate seller, a private equity seller typically resists giving non-compete and (to a lesser extent) non-solicitation covenants. This is in line with the principle of limiting all residual liability in order to achieve a clean exit. Furthermore, it is problematic for private equity funds to take on, for instance, non-competes, as it is their primary line of business to acquire and divest companies. If any such covenants are given, they are typically limited to non-solicitation of key employees for a restricted period of time, and do not extend to portfolio companies. A private equity seller does, however, typically assume customary confidentiality undertakings.

6.11 Commonly Litigated Provisions

Litigation is not common in relation to Swedish private equity transactions. The undertakings which private equity funds submit themselves to are usually limited, which limits the potential for litigation.

The most commonly disputed provisions are related to purchase price mechanics. Closing balance sheets and other true-up mechanics are predominantly determined by an expert appointed by the parties, and therefore are usually not subject to actual litigation.

Warranty and indemnity claim-related litigation between the parties is also limited, partly due to the fact that RWI is commonly taken out. The most dispute-driving warranties are those relating to financial information and tax.

7. Takeovers

7.1 Public-to-Private

Public-to-privates in private equity transactions have become common in recent years. Examples of such public-to-private offers that have been announced in recent years are CVC Funds' and Waldakt's joint bid on Resurs (June 2024), EQT's bid on OX2 (May 2024), Greenoaks' and Long Path's joint bid on Karnov (May 2024), Stirling Square's, TA's and Macquaire's joint bid on Byggfakta (January 2024), Nordic Capital's and CVC Funds' joint bid on Cary Group (June 2022), Basalt's bid on Nobina (December 2021), Advent's and GIC's joint bid on Swedish Orphan Biovitrum (September 2021), EQT's bid on Recipharm (December 2020), and Altor's and Stena Adactum's joint bid on Gunnebo (September 2020).

In a public offer situation, the target board must observe its fiduciary duties, the principle of equal treatment of shareholders as well as the general principles of respect for the stock market and respect for shareholders' rights to decide on a public offer.

The target board also has certain information obligations, and must inform the stock exchange if an offer is imminent and likely to proceed. Leakages or rumours regarding a potential public offer may trigger an obligation for the target company to make a public announcement under the EU market abuse regulation. The target board must also, no later than two weeks prior to the expiry of the acceptance period, issue a public statement expressing its opinion of the offer and the reason for its opinion. The target board commonly supports its statement with a fairness opinion from a financial adviser.

There is a general prohibition on the target company to agree on "deal protection" measures and relationship agreements. Transaction agreements, other than customary confidentiality agreements, are therefore not common.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

If an investor acquires 5% (or more) of the shares or votes in a company whose shares are listed on a regulated market in Sweden, the investor will be obliged to disclose its shareholding (subject to certain exemptions). The same applies at each consecutive 5% threshold up to 30% and then at 50%, 66⅔% and 90%. Certain "acting in concert" rules apply in relation to these disclosure obligations.

7.3 Mandatory Offer Thresholds

A party who holds no shares or holds shares representing less than 30% of the votes in a company whose shares are listed on a regulated market (or certain other marketplaces) in Sweden and who, through acquisition of shares in such company, attains a shareholding representing at least 30% of the votes in the company, will be obliged to announce a mandatory offer.

The shareholdings of certain natural or legal persons that are related parties to the shareholder should also be included when calculating the shareholder's shareholding. Such persons include the shareholder's group companies and a person with whom an agreement has been reached to adopt a long-term common position through the co-ordinated exercise of voting rights in order to achieve a controlling influence over the management of the company or who otherwise co-operates with the shareholder in order to obtain control of the company.

The obligation to announce a mandatory offer does not, however, apply if the shareholder's shareholding reaches or exceeds the 30% threshold following completion of a voluntary public offer for all shares in such company referred to in the above paragraph.

7.4 Consideration

Cash consideration is more commonly used as consideration in Swedish public offers. In recent years, more than nine-tenths of the public offers that have been announced have involved all-cash consideration.

Any acquisition of or agreement to acquire shares made by the bidder (or a member of a bid consortium or any closely related person to the bidder or a member of a bid consortium) during a period commencing six months prior to the launch of the public offer creates a "floor price" for the subsequent public offer. The same applies to any such transactions made during the offer period and during a period ending six months after the closing of the offer.

7.5 Conditions in Takeovers

An offeror is allowed to announce a public offer that is subject to conditions for completion, which is also customary. If a public offer is subject to such conditions, the conditions must be worded in such detail that it is possible to determine whether the conditions have been fulfilled. In addition, the conditions must be objective and may not be worded in a way that gives the offeror a decisive influence over their fulfilment. An exception from this principle is that the offeror may make the offer conditional upon receiving the necessary regulatory approvals, for example, competition clearance, on terms that are acceptable to the offeror.

Customary Conditions for Completion

The following conditions are the most commonly used conditions for completion in Swedish takeovers (regardless of whether the offer is a private equity-backed takeover offer or not):

- the offer being accepted to such an extent that the offeror becomes the owner of more than 90% of the shares in the target company (this being the threshold for initiating a compulsory buyout procedure pursuant to the Swedish Companies Act);
- with respect to the offer and the acquisition of the target company, the receipt of all necessary regulatory, governmental or similar clearances, approvals and decisions (including from competition authorities and agencies screening foreign direct investments), in each case on terms that, in the offeror's opinion, are acceptable;
- no other party announcing an offer to acquire shares in the target company on terms that are more favourable to the shareholders of the target company than the terms of the offer;
- neither the offer nor the acquisition of the target company being rendered wholly or partially impossible or significantly impeded as a result of legislation or other regulation, any decision of a court or public authority, or any similar circumstance;
- no circumstances having occurred that have a material adverse effect, or could reasonably be expected to have a material adverse effect, on the target company's financial position, prospects or operations, including the target company's sales, results, liquidity, equity ratio, equity or assets;
- no information made public by the target company, or disclosed by the target company to the offeror, being inaccurate, incomplete or misleading, and the target company having

made public all information that should have been made public by the target company; and
- the target company not taking any action that is intended to impair the prerequisites for making or completing the offer.

Offerors usually reserve the right to withdraw their offer in the event that it is clear that any of the above conditions for completion is not satisfied or cannot be satisfied. However, with the exception of the 90+% shareholding condition mentioned in the first bullet above, the offer may only be withdrawn where the non-satisfaction of the condition is of material importance to the offeror's acquisition of the target company or if otherwise approved by the Swedish Securities Council. Offerors may also (and usually do so) reserve the right to waive, in whole or in part, one or several of the conditions for completion referred to above, including, with respect to the 90+% shareholding condition, to complete the offer at a lower level of acceptance.

Financing

Before announcing an offer, the offeror must ensure that it has sufficient financial resources to complete its offer. This means that debt financing (if any) must have been secured on a "certain funds" basis. If the offeror has to raise equity capital in order to finance its offer, the offeror must have obtained subscription and/or underwriting commitments to ensure that the required equity capital can be raised. If conditions for the payment of a required acquisition credit are not included as conditions for completion of the offer (it should be noted that the scope for including such financing conditions is limited), these must be conditions that the offeror can ensure are met in practice.

Deal Security Measures

In general, a target company is prohibited from taking deal protection measures that oblige the target company in relation to the offeror, including, among other things, so-called no-shop clauses that restrict the target company from holding discussions with or seeking competing offerors. Accordingly, in addition to stakebuilding, the primary deal certainty measures that an offeror may take are to obtain irrevocable commitments from principal shareholders of the target company and secure a recommendation from the target board.

7.6 Acquiring Less Than 100%

The Swedish Companies Act permits compulsory buyout of minority shareholdings by a shareholder who, either alone or together with its subsidiaries, owns more than 90% of the shares of a Swedish limited liability company.

A compulsory buyout procedure following a public offer normally goes on for one to two years. However, if the majority shareholder (this being the offeror) so requests, and provides sufficient collateral, the majority shareholder may be granted advance vesting of title to the remaining shares in a separate award or judgment prior to the final determination of the purchase price for the shares. If the majority shareholder requests advance vesting of title and provides sufficient collateral, it usually takes about four to six months before the advanced vesting of title is granted, after which the majority shareholder can start treating the target company as a wholly-owned subsidiary.

If the offeror does not obtain enough acceptances in a public offer to reach an ownership of more than 90% of the shares in the target company, it will be difficult for the offeror to achieve a delisting of the target company, meaning that

the target company will still be subject to the listing requirements of the stock exchange (or other marketplace) on which its shares are listed. In addition, the remaining shareholders will be entitled to certain minority shareholders' rights preventing the offeror from obtaining full control over the target company, and without 100% ownership, a private equity-backed bidder will in practice not be able to achieve a debt push-down.

A shareholder (or group of shareholders) holding at least 10% of the shares in a Swedish limited liability company may request that an extraordinary general meeting of such company is held. Accordingly, the offeror can request that an extraordinary general meeting of the target company be convened and then elect a new board of directors of the target company at such meeting, which enables the offeror to, in practice, but subject to board members' fiduciary duties to the target company and all its shareholders, obtain control over the target company.

7.7 Irrevocable Commitments

It is common to obtain irrevocable commitments from principal shareholders of a target company. Such irrevocable commitments are usually negotiated prior to announcement of an offer (sometimes even prior to the target board being approached by the offeror).

It is more common with so-called "soft irrevocables" providing the shareholder an out if a better offer is made (sometimes only where the consideration offered by the competing offeror exceeds certain levels), but so-called "hard irrevocables" are sometimes given by shareholders, especially where the bidder has a strong position and/or where principal shareholders are eager to sell their shares and solicit the public offer.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentivisation of the management team (and sometimes top performers outside of the management team) is a common feature in private equity transactions in Sweden, and an important part of aligning interests between owners and managers/employees.

The level of equity ownership depends on various factors, including whether the management team owned equity prior to the private equity buyer's acquisition or not. When acquiring a founder-owned company, it is common for the private equity fund to acquire a smaller majority stake, and for the founders to be expected to reinvest a substantial part of the purchase price, typically from 30% to 50% net of tax and transaction costs. If the private equity fund acquires a business in a secondary sale, the management is also expected to reinvest a significant portion of their proceeds, but unless they originally founded the target, they would typically hold a smaller level of equity, ranging from a total of 5% to 15%.

If the management team or other top performers do not have equity ownership prior to the acquisition by the private equity buyer, it is not uncommon for them to be expected to make cash investments in connection with closing to ensure alignment. Given the typically large value of companies acquired through this type of transaction, the level of equity ownership would be small. Generally speaking, the pot for management equity decreases as the deal's enterprise value increases.

8.2 Management Participation

The equity in the management investment vehicle is typically divided into preference shares

and ordinary shares. Since the preference shares have a fixed rate of return, often corresponding to the subscription amount of the preference shares plus an annual coupon on the subscription amount, the upside of the investment flows through the ordinary shares, which are entitled to all dividends in excess of the return allocated to preference shares. Instead of having typical share structures as just described, hurdle shares are sometimes created. Hurdle shares are instruments similar to stock options – ie, the value of the target company needs to have increased enough for the hurdle shares to be in the money, and are otherwise worthless. Hurdle shares can usually be acquired for a lower purchase price than "normal" shares.

Sweet equity typically comprises approximately 80% ordinary shares and 20% preference shares, while the ratio for institutional strip is the opposite – ie, typically approximately 80% preference shares and 20% ordinary shares. It is uncommon for management and key employees to subscribe for 100% ordinary shares.

Management typically invest on the same level in the acquisition vehicle structure – ie, in a three-tier holding structure, and the management team owns shares either in the parent company alongside the private equity fund or in a company directly below the parent company.

In order to facilitate a future exit, it is fairly common to pool management and employee investors in a separate holding entity (MIPCo/KIPCo/EIPCo), in particular where the buyer launches a wider programme for non-key employees to allow them to make smaller investments.

8.3 Vesting/Leaver Provisions

Management and key employees typically acquire shares at the same time as the buyer (at the closing of the transaction). Certain managers may also top up their initial investments and new joiners would invest when joining the target company.

It is fairly common for private equity funds in Sweden to apply value vesting provisions. The value of the sweet equity vests over time, usually over two to six years, entailing that the value which the management or employee investors receive for their investment if they leave increases over time.

The typical leaver provisions in Sweden include those for a:

- good leaver;
- bad leaver; and
- intermediate leaver.

The criteria for defining the different leaver categories are a subject of negotiation between the management team and other employees invited to invest on the one hand, and the private equity buyer on the other hand.

Good leaver events typically include events such as retirement, long-term illness or death. A good leaver event commonly allows the individual to receive the fair value for its shares.

Bad leaver events typically include summary dismissal by the employer or other material breach by the leaver of the shareholder's agreement and/or its employment agreement. Bad leaver events typically entitle the manager to the lower of (i) the cost (the amount invested by the individual), and (ii) the fair value of the shares with a discount (usually around 75%).

Intermediate leaver events typically include termination of the employment by the employer

(other than summary dismissal), and termination of the employment by the employee. Interim leavers typically entitle the manager to the fair value of the vested shares and acquisition cost for the unvested shares.

The leaver provisions are typically structured as call options granted to the private equity majority owner, which exercises the option upon a leaver event occurring.

8.4 Restrictions on Manager Shareholders

In private equity transactions on the Swedish market, there are often overlapping restrictive covenants in (i) the transaction documentation (usually a share purchase agreement), (ii) the terms of the MIP/KIP/EIP-programme, and (iii) the employment agreement of the management or employee shareholder. Non-compete provisions and non-solicit provisions are customary in all three documents. In the transaction document, restrictive covenants usually expire 18–24 months following closing, although they sometimes last longer. The restrictive covenants contained in the terms of the MIP/KIP/EIP-programme usually expire 12–24 months after the shares are sold. A non-compete in an employment agreement is most commonly limited to 6–12 months following termination of employment.

In addition to the above restrictive covenants, there are certain kinds of actions by the employee which usually constitute call option events under the leaver provisions in the MIP/KIP/EIP-programme. These include disparagement, fraud against the company and other crimes against the company.

8.5 Minority Protection for Manager Shareholders

Management and employee shareholders typically expressly disclaim any minority protection rights granted to them under the Swedish Companies Act, and are typically not granted any veto rights.

Management and employee shareholders typically obtain anti-dilution protection, which is customarily subject to carve-outs such as issues to reinvesting managers, finance providers and other third parties. It is uncommon for management shareholders to be entitled to director appointment rights; however, in founder-owned businesses it is more common, and even more so if the founder shareholders retain a large stake in the target.

Management and employee shareholders typically do not have any right to influence the exit of the majority owner. They are typically expected to enter into transaction documentation on the same terms as the private equity fund (ie, on the terms negotiated by the private equity fund). Management and employee shareholders do, however, typically enjoy certain protective limitations, such as a time limit for the duration of a lock-up in an IPO, and the duration of non-compete and non-solicitation covenants towards the buyer in a trade sale.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

Private equity funds in Sweden have traditionally almost exclusively made control investments. As outlined in **8.1 Equity Incentivisation and Ownership**, it happens that the private equity fund only acquires a weak majority when buy-

ing founder-led targets, and as outlined in **5.4 Multiple Investors**, minority investments are increasing.

Voting differences entailing that the private equity buyer holds shares with stronger voting powers than management and employee shareholders are commonly used to ensure control. Under Swedish law, shares without voting rights are not permitted.

By holding a majority stake or the majority of votes in the target, the private equity buyer controls the decisions taken at shareholder level and, consequently, at board level by controlling the appointment of the board and the chief executive officer. In Sweden, private equity governance typically gives the chief executive officer control of the daily operations of the business of the target, while certain matters are reserved for the board and/or require shareholder approval under law and/or agreement.

Where the investment structure entails multiple shareholders, a shareholders' agreement will almost always be entered into, and usually include veto catalogues in favour of the private equity buyer.

It is also usual to implement governance documents setting out structures for decision-making, including pre-determined matters which have to be raised at board or shareholder level. The most common governance documents implemented are rules of procedures for the board, instructions to the chief executive officer and instructions for financial reporting.

9.2 Shareholder Liability

The fundamental principle under Swedish company law is that the shareholder's liability for the actions of the limited liability company is limited to the equity paid into the company. There are exceptional circumstances under which the corporate veil can be pierced and there can be shareholder liability, but these circumstances are limited to situations when the shareholder has intentionally exploited and misused the limited liability granted to the company as a legal person.

10. Exits

10.1 Types of Exit

The typical holding period for investments made by private equity funds is approximately three to five years.

Dual-track is the starting point for most mid- and large-sized transactions, with enhanced focus either on IPO or trade sale depending on market conditions. Triple-track exits have been and continue to be uncommon. Continuation funds have emerged as an alternative exit route for private equity funds that want to keep well-performing assets as their funds near the end of their terms, or that otherwise need additional time to provide sufficient returns.

Given the uncertainties in the stock market since 2022, trade sales have become the predominant exit route, whereas during the last five years before 2022, mid- and large-sized exits were more commonly conducted as IPOs.

10.2 Drag and Tag Rights

Drag rights entail an obligation for minority holders (both management and employee shareholders, and institutional co-investors) to sell their shares to a buyer elected by the private equity fund on terms not less favourable than those offered to the private equity fund as majority

holder. The typical drag threshold in Sweden is 50%, or a change of control of the target.

Shareholder agreements in Sweden typically include drag rights for the private equity fund as majority owner, in order to secure the possibility to sell 100% of the equity in the target business at exit. Usually, the drag right does not have to be formally enforced.

It is most common that dragged sellers sell through the main transaction document (often by adherence), but it does occur that dragged sellers sell through separate short-form agreements.

As a trade-off for agreeing to drag rights, management, employee and other minority shareholders (including institutional co-investors) typically enjoy tag-along rights in the sale when the private equity fund majority shareholder sells its shares in the company in a trade sale or by floatation. The typical tag threshold is the same as the drag threshold.

10.3 IPO

Elevated valuations rendered favourable IPO exit conditions in the period 2017–2021. The generally lower valuation of public companies since 2022 has resulted in less favourable IPO exit conditions, and as a consequence the IPO activity in Sweden ground to a near halt in 2022, slowly returning during the first half of 2024.

The typical lock-up arrangement for a private equity seller restricts the sellers that remain shareholders following the flotation from selling their shares (and other financial instruments in the issuer), typically for a period of 180 calendar days. The restriction is normally subject to several customary exceptions, for example, intra-group transfers and public takeover offers. While it is uncommon, the lock-up can also be waived by the investment bank(s) before the lock-up period has expired. Relationship agreements are generally prohibited.

Trends and Developments

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Introduction

As we move through 2024, Sweden's private equity (PE) landscape reflects a market that has been resilient in the face of significant macroeconomic challenges. While the state of the global economy remains uncertain, recent and upcoming rate cuts and seemingly abated inflation have led to increased activity among investors. This is also what the market indicates – the second quarter of 2024 has seen the strongest PE activity in two years.

The Swedish market remains robust, with opportunities emerging in sectors like renewable energy, technology, and life sciences. This article explores the key trends and developments shaping the Swedish PE landscape in 2024, offering insights into how firms are navigating these complexities and are positioning themselves for future growth.

Economic Context and Market Dynamics

Macroeconomic challenges and opportunities

The Swedish economy, mirroring global trends, is showing signs of recovery from a period of elevated inflation and interest rates. The Swedish Central Bank's (*Riksbanken*) aggressive rate hikes aimed at curbing inflation have strained liquidity, making capital more expensive and less accessible. This has impacted the ability of PE firms to raise new funds, with many experiencing prolonged fundraising periods and reduced investor appetite. However, with inflation in Sweden reaching the target benchmarks, and rates being cut twice by the Riksbank in 2024 (with additional cuts on the way), PE actors are already beginning to see some light at the end of the tunnel after two years of macroeconomic challenges.

In Sweden, the combination of lower interest rates and a strong, export-driven economy is expected to enhance the attractiveness of investment opportunities, particularly in sectors like technology and renewable energy. However, PE firms must remain vigilant of potential economic headwinds, including the lingering effects of inflation on consumer spending and the cost of capital.

Impact on deal-making and fundraising

The high cost of capital has led to a more cautious approach to deal-making in the Swedish PE market. However, deal activity showed significant signs of recovery in the second quarter of 2024, with deal values and deal volume

significantly increasing on a quarter-to-quarter basis. This indicates that investors are willing to commit larger sums to high-quality assets, especially in Sweden, where this trend is particularly evident in the technology and cleantech sectors.

While the median timeframe for closing fundraising rounds is approximately 18 months by mid-2024, up from 12 months in 2022, established PE firms with proven track records have still successfully secured significant capital and closed large funds. The prolonged fundraising timeframes may, however, have been a factor in an increased number of co-investment transactions, where limited partners (LPs) invest alongside the PE firm in specific deals. This approach not only helps to spread the risk but also allows LPs to deploy capital more selectively, focusing on high-conviction investments. For PE firms, co-investments can be a valuable tool for bolstering deal capacity without diluting their equity stake.

Sectoral Trends and Investment Focus

Renewable energy and green transition

One of the most prominent trends in the Swedish PE market is the growing focus on sustainable investments, particularly in renewable energy and green technology. The global push towards net-zero emissions has accelerated investment in sectors like wind and solar power, energy storage, and electric mobility. Swedish PE firms are increasingly targeting companies that are leading the charge in these areas, not only for their growth potential but also for their alignment with environmental, social, and governance (ESG) principles.

The Swedish government's commitment to reducing carbon emissions and its supportive regulatory environment have further bolstered the attractiveness of the renewables sector. For instance, Sweden aims to become one of the world's first fossil fuel-free welfare nations, and this ambition is driving substantial investments in renewable energy infrastructure. PE firms are capitalising on this trend by investing in both established companies and innovative start-ups that are developing cutting-edge technologies for the energy transition.

Moreover, the rise of green bonds and sustainable financing has provided additional capital sources for PE firms focused on ESG-compliant investments. These instruments are becoming increasingly popular among institutional investors seeking to align their portfolios with sustainable development goals (SDGs). PE firms can leverage green bonds to finance large-scale renewable projects, thus reducing their reliance on traditional equity or debt financing.

Additionally, Sweden's leadership in the circular economy – an economy where resources are reused and recycled to minimise waste – is attracting PE interest. Companies that innovate in areas like sustainable packaging, waste management and resource efficiency are becoming prime targets for acquisition. The circular economy not only aligns with global sustainability trends, but also offers significant cost savings and new revenue streams for portfolio companies.

Technology and digitalisation

Technology continues to be a critical area for PE investment, driven by the ongoing digital transformation across industries. In 2024, Swedish PE firms are particularly interested in vertical software-as-a-service (SaaS), fintech, and cybersecurity companies.

These sectors offer robust growth prospects, fuelled by the increased demand for digital solu-

tions in a post-pandemic world. Moreover, the rapid adoption of artificial intelligence (AI) and machine learning (ML) technologies presents new opportunities for value creation within portfolio companies.

Life sciences and healthcare

The life sciences and healthcare sectors remain attractive to PE investors due to their resilience and growth potential. Sweden's strong healthcare system provides fertile ground for investments. We anticipate continued interest in companies involved in drug development, medical devices, and healthcare services, particularly those that leverage technology to improve patient outcomes and operational efficiency.

Sweden's strong regulatory framework and its reputation for high-quality clinical trials make it an attractive destination for biotech investments. PE firms are particularly interested in companies developing innovative therapies in areas such as oncology, immunology, and rare diseases. The potential for high returns in these areas, coupled with the relatively low cost of development compared to the USA, make Swedish biotech companies compelling investment targets.

Regulatory Landscape

Foreign direct investment (FDI) regulations

A significant development in the regulatory landscape is the introduction of a more stringent foreign direct investment (FDI) regime in Sweden. This regime broadens the scope of investments subject to scrutiny, covering not only controlling stakes but also non-controlling minority investments in sectors deemed critical to national security, such as technology, healthcare, and energy.

The FDI regime's broad scope means that even small investments can trigger regulatory review, particularly if they involve sectors considered vital to national security. This includes not only traditional defence-related industries, but also sectors like telecommunications, energy infrastructure, and healthcare, which have become increasingly sensitive in light of heightened geopolitical tensions.

For PE firms, this regulatory environment requires a more strategic and cautious approach to deal-making. Early engagement with regulatory authorities and thorough compliance planning have become essential to avoid delays and potential deal cancellations. In some cases, PE firms may need to structure deals in a way that mitigates national security concerns, such as by limiting foreign ownership or ensuring that sensitive operations remain under Swedish control.

The introduction of the FDI regime has also led to a rise in voluntary notifications, where firms seek regulatory clearance proactively, even when not strictly required. This approach helps to reduce uncertainty and provides greater deal security, particularly in sectors where the regulatory landscape is still evolving. However, the additional compliance burden can increase transaction costs and extend timelines, which PE firms must factor into their overall deal strategy.

National security concerns

In addition to the FDI regime, the Protective Security Act continues to play a crucial role in governing transactions involving security-sensitive activities. The broad scope of this legislation, covering both domestic and foreign transactions, requires careful consideration by PE firms when structuring deals. The mandatory consultation and approval process, although time-consuming, is essential to ensure compliance and avoid potential roadblocks.

National security concerns have become increasingly prominent in Sweden, reflecting global trends where governments are more vigilant about the ownership and control of critical infrastructure and technology. PE firms investing in these sectors must navigate a complex regulatory environment which to a higher degree prioritises national interests over commercial considerations. This can involve negotiations with multiple stakeholders, including government agencies, to secure the necessary approvals.

The lack of statutory timelines for national security reviews adds another layer of uncertainty. While a three-month review period is typical, more complex cases can take longer, particularly if sensitive issues arise during the consultation process. PE firms must therefore build flexibility into their deal timelines and be prepared for potential delays. In some cases, firms may opt to include conditions precedent in their agreements, allowing them to withdraw from the deal if approval is not granted within a certain timeframe.

ESG regulations

ESG considerations have become increasingly integral to the due diligence and fundraising process in the Swedish PE market. Swedish regulators and investors alike are placing greater emphasis on the ESG credentials of target companies. Such emphasis is also being placed on PE firms, particularly in terms of their environmental impact and governance practices. Going forward, we expect ESG factors to continue to influence investment decisions and post-acquisition strategies, with firms seeking to enhance the sustainability and social responsibility of their portfolio companies – as well as the governance of the firms themselves as they increase in size and global reach.

The growing importance of ESG in the investment and fundraising process reflects a broader shift in the global financial markets, where sustainability and ethical considerations are becoming mainstream. For PE firms, integrating ESG into their investment strategies is no longer optional – it is a necessity to meet the expectations of investors, regulators, and the wider public. PE firms will need to be weary in this context of practices being labelled as greenwashing.

Larger Swedish companies generally have the obligation for separate sustainability reporting, however, the European Corporate Sustainability Reporting Directive (CSRD) has thoroughly extended such disclosure obligations. Furthermore, the Sustainable Finance Disclosure Regulation (SFDR) imposes significant reporting obligations on companies and PE firms alike. Compliant reporting is more and more requiring additional legal input in an area which previously has not been as heavily regulated – which becomes even more important for PE firms in light of the value-driving aspect of ESG in their investments.

PE firms are increasingly using ESG due diligence not only to assess risks but also to identify opportunities for value creation. For instance, by improving the energy efficiency of portfolio companies or enhancing their social impact, firms can not only meet regulatory requirements but also drive long-term growth and profitability. Moreover, strong ESG performance can enhance a company's attractiveness to future buyers, particularly in sectors where sustainability is a key differentiator.

Deal-making Environment

Due diligence and risk management

The current economic and regulatory climate has necessitated a more rigorous approach to due

diligence in PE transactions. Early-stage due diligence now often includes a red flag analysis to identify potential regulatory constraints, such as antitrust, national security and FDI issues, as well as other high-risk areas like anti-bribery and corruption matters.

Given the increasing complexity of regulatory compliance, PE firms are investing in advanced due diligence tools and technologies to streamline the process. This includes the use of AI-powered data analytics to identify potential red flags across large volumes of data, as well as digital platforms that facilitate the secure sharing and analysis of due diligence information among multiple stakeholders.

The increased use of warranty and indemnity (W&I) insurance in Swedish PE transactions has also influenced due diligence practices. W&I insurance provides coverage for breaches of warranties in sale and purchase agreements, allowing sellers to achieve a "clean exit" with limited residual liability. For buyers, W&I insurance reduces the risk of post-transaction disputes, providing greater deal certainty. As a result, due diligence processes are increasingly tailored to meet the requirements of W&I insurers, with a focus on the issues that are most likely to impact coverage.

Moreover, the trend towards more thorough due diligence is reflected in the increasing use of vendor due diligence (VDD) reports. These reports, prepared by the seller and its advisers, provide a comprehensive overview of the target company's financial, legal, and operational status, and are shared with potential buyers to facilitate the transaction process. While VDD reports can expedite the deal process by reducing the need for buyers to conduct their own extensive due diligence, they also place a greater onus on sellers to ensure the accuracy and completeness of the information provided.

Valuation and negotiation trends

The valuation gap between buyers and sellers, which widened during the market volatility of 2022-2023, is gradually narrowing. However, there remains a degree of caution among buyers, leading to more protracted negotiation processes. Sellers, on the other hand, are increasingly willing to accept alternative payment structures, such as earn-outs and vendor loans or other types of deferred payment mechanisms, to bridge valuation differences and secure deals.

In the current market environment, deal pricing is also influenced by macroeconomic factors, such as interest rates, inflation, and currency fluctuations. Buyers are demanding greater discounts to account for the increased cost of capital and the uncertain economic outlook. This has led to a resurgence of deferred payment structures, where part of the purchase price is contingent on the future performance of the target company. These structures not only align the interests of buyers and sellers but also provide a mechanism to manage valuation risks in an uncertain market.

The use of locked-box mechanisms, which provide price certainty by fixing the purchase price at an agreed date prior to the completion of a transaction, remains common. However, in the current market environment, we are also seeing a resurgence of closing accounts mechanisms, which adjust the purchase price based on the target's financial position at closing. This approach allows for greater flexibility in deal-making, particularly in volatile markets.

Additionally, the increasing prevalence of ESG considerations in deal negotiations is influencing

valuation discussions. Companies with strong ESG credentials may command a premium, while those with significant ESG risks may face discounts or require additional warranties to mitigate potential liabilities. This trend reflects the growing importance of ESG as a value driver in PE transactions and underscores the need for thorough ESG due diligence as part of the valuation process.

Portfolio Management and Exit Strategies

Add-on acquisitions and value creation

With fewer opportunities for large-scale acquisitions, many PE firms in Sweden are focusing on add-on acquisitions to bolster their existing portfolio companies. This strategy allows firms to enhance the value of their portfolios through synergies, scale, and market share growth. Additionally, firms are placing a greater emphasis on ESG initiatives as key drivers of value creation.

Add-on acquisitions, where a portfolio company acquires smaller firms to expand its capabilities or market reach, have become a cornerstone of value creation strategies. These acquisitions are often more manageable and less risky than large-scale buyouts, particularly in a challenging market environment. By integrating these add-ons into their existing portfolio companies, PE firms can realise synergies that drive growth and improve margins.

ESG initiatives are also playing an increasingly important role in value creation. By improving the sustainability and social impact of their portfolio companies, PE firms can not only enhance financial performance but also mitigate risks and improve the attractiveness of these companies to future buyers. This includes initiatives to reduce carbon emissions, improve labour practices, and enhance corporate governance, all of which are becoming increasingly important to investors and stakeholders.

Exit strategies and market timing

The uncertain market conditions have prompted a more cautious approach to exits, with some firms opting to delay sales until market conditions improve. Dual-track processes, which keep both IPO and trade sale options open until late in the exit process, have become more common. This approach provides flexibility and maximises the chances of a successful exit, particularly in volatile markets. However, it also requires careful planning and execution, as the requirements for an IPO and a trade sale differ significantly.

The IPO market has been particularly challenging in recent years, with increased market volatility and regulatory scrutiny leading to a considerable decline in new listings on the Swedish stock exchanges. As a result, many PE firms have opted for trade sales as a more reliable exit route. This trend continues in 2024, with strategic buyers and other PE firms remaining active in the market, particularly for high-quality assets with strong growth potential.

For firms that choose to pursue an IPO, careful timing is critical to success. This involves not only choosing the right moment to launch the offering, but also ensuring that the portfolio company is well-prepared for life as a public company. This includes strengthening the company's governance, ensuring compliance with regulatory requirements, and building a strong investor relations strategy.

Future trends and opportunities

Looking ahead, we expect several key trends to shape the Swedish PE landscape. The ongoing digital transformation, driven by AI and ML, will continue to create new investment opportunities

in technology and adjacent sectors. Similarly, the global shift towards sustainability and green energy will spur further investment in renewables and other environmentally focused industries.

As the world continues to grapple with the challenges of climate change, the demand for sustainable solutions will only grow. PE firms that position themselves at the forefront of this transition, investing in companies that are driving the green economy, will be well placed to capitalise on these opportunities. This includes not only investing in renewable energy but also in companies that are developing innovative solutions for resource efficiency, waste reduction, and sustainable consumption.

Regulatory scrutiny is likely to intensify, particularly in relation to FDI and ESG. PE firms will need to navigate these challenges carefully, ensuring that they remain compliant while still capitalising on emerging opportunities. This will require a proactive approach to regulatory engagement, with firms working closely with regulators to ensure that their investments align with national priorities and comply with evolving standards.

Strategic Recommendations

To succeed in this evolving landscape, PE firms should adopt a proactive approach to regulatory compliance, particularly concerning ESG, FDI and national security laws. Engaging in early-stage consultations with legal advisers in these matters can help mitigate risks and streamline deal approvals.

Additionally, investing in talent and building strong operational capabilities within portfolio companies will also be critical. This includes not only financial and strategic acumen, but also a strong understanding of regulatory and ESG issues.

Conclusion

The Swedish private equity market in 2024 is characterised by both challenges and opportunities. While macroeconomic and regulatory pressures are significant, they also create a dynamic environment where strategic, well-informed investment decisions can yield substantial rewards. By staying attuned to market trends, regulatory developments, and sector-specific opportunities, PE firms can continue to thrive in this complex landscape.

SWITZERLAND

Law and Practice

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

The anticipated economic recovery following the pandemic did not materialise in 2023. Despite robust performance in 2022, the year 2023 was merely average in terms of transaction numbers and marked the second lowest transaction volume of the past decade. Swiss entities engaged in 484 transactions amounting to USD72.2 billion. Even within a ten-year comparative framework, 2023 is notable for its low transaction volume, surpassed only by the year of the COVID-19 outbreak in 2020. The most significant transaction was the USD17.3 billion merger between Bunge and Viterra, followed by Roche's acquisition of Telavant, a biotech company for around USD7.3 billion. In terms of transaction numbers, 2023 was an average year in a ten-year comparison but did not reach the exceptionally high levels of the preceding two.

Entering 2024, the M&A landscape continued to face significant challenges. By mid-year, global deal volumes were 30% lower than in the first half of 2023, impacted by uncertainties and delayed interest rate reductions in the United States. The Swiss State Secretariat for Economic Affairs (SECO) forecasts modest economic growth of 1.1% for Switzerland in 2024, consistent with the IMF's global forecast of 2.9%, both below historical averages. Contributing factors include the lingering effects of the pandemic, geopolitical conflicts, and tight monetary policy in many countries, all of which hinder a robust recovery.

Notwithstanding these challenges, there is optimism for the Swiss M&A market in 2024. Stakeholders are encouraged by improving macroeconomic and political conditions, and a resolution to interest rate uncertainties. Private equity firms are under pressure to increase their activity, leveraging substantial "dry powder" for investments and benefiting from improved access to debt financing. This sets the stage for a potential catch-up effect, with deferred M&A projects from 2023 likely to come to fruition in 2024.

Positive indicators have emerged, with deal values increasing by 5% in the first half of 2024 and the announcement of 33 "mega-deals", representing a 22% year-on-year increase. Additionally, the Swiss fund market achieved an all-time high of CHF1.5 trillion in the first quarter. Thorough preparation and renewed confidence are essential to revitalising M&A activities: as deal preparation accelerates and confidence returns, the Swiss M&A market is poised to regain momentum.

1.2 Market Activity and Impact of Macro-Economic Factors

In 2023, the most active sectors in the Swiss M&A market were industrial markets; technology, media, and telecommunications (TMT); and pharmaceuticals and life sciences. The industrial goods sector accounted for 98 transactions with a deal volume of approximately USD6 billion, representing 20% of all transactions. This is the first since the coronavirus crisis that the industrial goods sector has surpassed the TMT sector as the most active in M&A activity.

The TMT sector, with 76 transactions and a deal volume of slightly over USD1.1 billion, experienced a significant decline compared to the previous year's 124 transactions and nearly USD15 billion in volume. Pharmaceuticals and life sciences maintained their third-place position from the previous year, with 72 deals but a volume of nearly USD25 billion.

Looking ahead, several macroeconomic factors could restore confidence and boost M&A activity. Despite the uncertain timing, the need for M&A is more pronounced, driven by pent-up selling pressure, particularly from private equity firms. Rapid technological advancements and the disruptive impact of artificial intelligence (AI) make M&A a strategic imperative for companies seeking growth and business model reinvention in a low organic growth environment. Increased preparations for sales and vendor due diligence indicate a potential influx of quality assets to the market in the near future.

However, the M&A landscape remains complicated by ongoing global tensions, including conflicts in Ukraine and the Middle East, and strained US-China relations. The rise of AI as a global trend in 2023 has positioned pioneering technologies as crucial to business operations. In addition to standard due diligence, both buyers and sellers should carefully prepare for IT integration or separation to accelerate success and create long-term value. Consequently, M&A activity is expected to increase, albeit unevenly across sectors.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

In general, private transactions are not extensively regulated in Switzerland and the parties have great flexibility in determining the transaction structure as well as the contractual framework. Compared to public M&A transactions, which are highly regulated, private M&A transactions are less densely governed and many provisions of the Swiss Code of Obligations of 30 March 1911 that would apply to share or asset transfers can be excluded in favour of a contractual framework.

However, financial and corporate regulations have increased in recent years. In this respect, it should also be noted that even though Switzerland is not a member of the European Union, EU directives and regulations still have an important impact on Swiss policy-making.

Data Protection and Privacy

An example of EU regulations affecting the regulatory landscape in Switzerland is the General Data Protection Regulation (GDPR). Even though Switzerland is not a member of the EU, the guidelines are directly applicable to all Swiss-based companies doing business in the EU, as the scope includes all businesses processing personal data of EU data subjects (eg, employees), or organisations that monitor the online behaviour of EU data subjects (eg, customers). In addition, EU companies are asking their Swiss business partners to be GDPR-compliant. Therefore, the GDPR has a major impact on numerous Swiss-based companies.

The Federal Act on Data Protection of 19 June 1992 (FADP), and the supporting Ordinance to the Federal Act on Data Protection of 14 June 1993 (DPO), has undergone a complete overhaul in Switzerland, partially in reaction to the GDPR and its ramifications. The purpose of the reform was to update the FADP to align with technological advancements, to ensure compliance with the GDPR and to maintain unrestricted data flow between Switzerland and the EU. The revised FADP, along with the associated legislation, has been in effect since 1 September 2023, without a transition period.

SPACs

Special purpose acquisition companies (SPACs) had record years in the USA in 2020 and 2021. In Switzerland, the Directive on the Listing of SPACs was put into effect in December 2021, allowing SPACs to be listed on the SIX Swiss Exchange. As a result, these "blank-cheque firms" have entered the Swiss "investor" market. This directive requires that the de-SPAC process be completed three years after the initial trading day. Otherwise, the SPAC has to be dissolved and liquidated, respectively, and the converted bond mandatorily repaid.

The first and sole SPAC in Switzerland was listed on 15 December 2021. Two years after listing, the company successfully found a suitable takeover target with a capital base of approximately CHF200 million. In December 2023, the target company's shares were listed on the SIX Swiss Exchange. There has not been an additional SPAC listed in Switzerland since.

Sparks

The Swiss Financial Market Authority (FINMA) approved the new SIX Swiss Exchange equity section "Sparks" in 2021. Since October 2021, SMEs have been eligible to list on the SIX under streamlined, SME-specific regulations, to get access to Swiss and foreign investors with sufficient financial means and experience. The benefits of Sparks also include enhanced liquidity due to the tradability and visibility of the shares, with the company needing to adhere to more stringent regulatory standards (such as ad hoc advertising, disclosure of large shareholdings, and financial reporting). Businesses and investors have additional chances to expand by enabling SMEs to take advantage of SIX's benefits. In February 2022, the first SME was listed in the new "Sparks" equity section of the SIX Swiss Exchange. Due to the limited number of stock market entries the SIX launched the "Sparks" IPO Academy for the second time in early 2023, with 15 potential stock market candidates participating. The Six Swiss Exchange is actively filling its pipeline in anticipation of the next stock market upswing.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Regulatory Reform

As mentioned in **2.1 Impact of Legal Developments on Funds and Transactions**, private M&A transactions are not extensively regulated in Switzerland as there is no specific act regulating the acquisition of privately held companies. The main legal source is the Swiss Code of Obligations, which provides quite a liberal framework for transactions. Currently, Swiss law provides for only very limited restrictions on foreign investment (for example, the banking sector or the purchase of residential real estate): foreign investors, financial sponsors, and sovereign wealth investors are, broadly speaking, in most cases not restricted or treated differently from domestic investors.

However, following international developments, this may change in Switzerland. An initiative to establish an approval authority for transactions subject to investment control (motion 18.3021 Rieder) was approved by the Swiss Parliament in March 2020, instructing the government to create a legal basis for controlling foreign investments, with the aim of safeguarding Switzerland's public order and security.

In May 2022, a first draft of the Investment Review Act (IPG) was published, encompassing investments by state-owned foreign inves-

tors in general, as well as investments in specific sectors by any foreign investor, regardless of whether it is controlled by a foreign state or a private entity. The publication of the first draft of the Investment Review Act was followed by a consultation period which lasted until September 2022.

In May 2023, the Federal Council took note of the results of the consultation on the new law on investment screening. The proposal has faced widespread scepticism, primarily due to concerns about its potential negative impact on Switzerland's attractiveness as a business destination. Consequently, the Federal Council has instructed the Federal Department of Economic Affairs, Education and Research (EAER) to prepare a substantially revised draft that aligns with Switzerland's international obligations and to present it to the Parliament.

According to the revised draft instructions provided by the Swiss government, the scope of investment review will be significantly limited. It will only be applicable when a foreign state-controlled investor acquires a domestic company operating in critical sectors such as defence equipment, electricity production and transmission, or health and telecommunication infrastructures. This reduced scope of the revised draft will significantly limit the adverse effects on companies compared with the initial draft. The Swiss Federal Council has directed the EAER to prepare the corresponding revised draft by the end of 2023. At the time of writing, there is no further development in the decree of the Investment Review Act (IPG).

The Foreign Subsidies Regulation

The new EU Foreign Subsidies Regulation (FSR) regime directly impacts Swiss companies with sales in EU member states, particularly if they are planning transactions in the EU or participate in public tenders there. Swiss companies should anticipate reporting obligations if certain thresholds are met and may also face ex officio investigations by the European Commission if they operate within the EU.

Subsidies from Swiss public bodies (the federal government, cantons, municipalities, etc) are considered grants under the FSR. This includes special tax breaks, individually granted support, and pandemic related assistance provided to individual companies. Additionally, Swiss companies must account for subsidies received from non-EU countries worldwide.

As a result, numerous M&A transactions and public tenders involving Swiss companies in the EU will likely need to be reported under the FSR. Companies should systematically collect information on all financial contributions or subsidies received globally and on a group-wide basis, noting whether these contributions were received under market conditions. This data is essential for assessing the reportability of corporate transactions or public tender offers under the FSR and for preparing a defence if subjected to an ex-officio investigation.

Real Estate

One exception to the liberal legal framework in Switzerland is the acquisition of real estate. Swiss law restricts the acquisition of real estate that is not permanently used for commercial purposes (non-commercial property), such as residential or state-owned property, undeveloped land or permanently vacant property (the Lex Koller). Legal entities with their corporate seat outside Switzerland are deemed as foreign under the regulations, regardless of who controls them. Further, legal entities with their corporate seat in Switzerland are deemed as foreign if they

are controlled by foreign investors. The law takes a very economic view to determine whether a Swiss entity is foreign controlled; namely, it looks through the entire holding and financing structure, but it is strictly formal as soon as an entity with its corporate seat outside Switzerland is involved.

ESG

The topics of sustainability and environmental protection, as well as social and responsible corporate governance, have gained increased attention and importance in Europe (and throughout the world) over the past few years (criteria of environmental social governance, ESG). With the introduction of ESG reporting requirements as of 1 January 2022, Switzerland has followed the trend and has introduced stricter ESG requirements for Swiss companies.

Depending on their size and significance, certain companies will be subject to the new ESG reporting requirements.

Swiss businesses that are of public interest must create an annual, public ESG report that addresses non-financial issues. The requirement to create such a report primarily pertains to listed companies and banks that, together with the domestic or foreign businesses they control, have an average of at least 500 full-time positions annually over the course of two years and have sales revenue exceeding CHF40 million or a balance sheet total of at least CHF20 million. The report discusses non-financial issues such the business strategy, newly developing threats to the environment, employees, and human rights, as well as the due diligence steps the firm has made to address ESG issues.

Compared to companies of public interest, SMEs are not yet compelled to issue such an ESG report. However, additional due diligence obligations apply if companies (including SMEs) with their registered office, head office, or primary place of business in Switzerland process or import specific minerals or metals originating from conflict or high-risk regions. Similar due diligence obligations apply to Swiss companies that provide goods or services for which there is a plausible suspicion that child labour was used in their manufacturing. SMEs are exempt from the due diligence obligations regarding child labour if their balance sheet totals, sales revenue and full-time employees fall below certain statutory thresholds.

It is anticipated that the due diligence obligations regarding child labour will be the most relevant obligation for private equity firms intending to invest in certain businesses. Moving forward, it is highly recommended that private equity buyers also focus on the new reporting requirements when conducting a due diligence analysis of an acquisition target.

With effect from 1 January 2024, the executive regulation on climate reporting for large Swiss enterprises was enacted. Publicly traded companies, banks, and insurance firms with a minimum of 500 employees and either a balance sheet total of at least CHF20 million or an annual turnover exceeding CHF40 million are now mandated to publicly disclose information on climate-related matters.

The mandatory public reporting must encompass both the financial risks associated with the entity's climate-relevant activities and the impact of the entity's business operations on the climate. Furthermore, entities are required to disclose their targets for reducing both direct and indirect greenhouse gas emissions and to outline their strategies for achieving these targets.

4. Due Diligence

4.1 General Information

The vast majority of legal due diligences are conducted on an exception basis only (ie, only highlighting red flags). Only in specific cases are summaries or overviews produced (eg, overview of key terms of the important business contracts, the employment agreements with key employees or lease overviews). The typical scope of a legal due diligence covers corporate matters, financing agreements, business agreements, employment (excluding social security and pension), real property/lease, movable assets, intellectual property (IP)/IT (review of an IP portfolio and contracts from a legal perspective), data protection and litigation. Compliance and regulatory topics are included to the extent relevant for the specific business.

4.2 Vendor Due Diligence

Vendor due diligence is not a customary feature in private equity transactions in Switzerland. However, it is conducted in complex and large-scale transactions to expedite and facilitate the sales process. Recently, there has been an increase in the frequency of sales preparations and vendor due diligence.

The result of a vendor due diligence is typically a report which summarises material legal key terms as well as highlighting certain red flags. The vendor due diligence reports are often used as a starting point for the buyer's own legal due diligence and to define the focus of the buyer's own due diligence. However, vendor due diligence reports usually do not fully replace a buyer's own due diligence – even if reliance is granted (which is typically the case).

5. Structure of Transactions

5.1 Structure of the Acquisition

Most acquisitions of Swiss target companies by private equity funds are carried out by Swiss law-governed share purchase agreements with jurisdiction in Switzerland. In the case of a reinvestment or a partial sale, a shareholders' agreement is concluded in connection with the transaction.

The terms of the acquisition are different between a privately negotiated (one-on-one) transaction and an auction sale, as the "hotter" the auction, the more seller-friendly the terms of the acquisition agreement. This relates to the price certainty (locked-box v closing adjustment), transaction certainty (conditions precedent (CP), hell or high-water clause, etc) as well as the liability concept (warranty and indemnity (W&I) insurance, cap, specific indemnities, etc).

5.2 Structure of the Buyer

Given the extensive flexibility in Switzerland, a wide array of transaction structures is observed. The predominant structure for private equity funds to invest in or acquire a Swiss target company involves the establishment of a special purpose acquisition vehicle, commonly referred to as NewCo or AcquiCo. The AcquiCo may be held either directly or, predominantly for tax or financing purposes, through another special purpose vehicle located in Switzerland or abroad. In anticipation of an exit and the associated potential liabilities, the fund typically refrains from becoming a party to the acquisition or sale documentation.

The acquisition structure is generally influenced by considerations of tax efficiency and financing, such as the tax-efficient repatriation of dividends, the application of double taxation treaties, and

ensuring a tax-exempt exit. A Swiss-domiciled seller or manager reinvesting in the AcquiCo may realise a tax-free capital gain upon the sale of AcquiCo during an exit. In an auction process, meticulous consideration of tax implications can provide a significant advantage to a bidder.

5.3 Funding Structure of Private Equity Transactions

Swiss transactions are typically still, at least partially, debt-financed. Due to negative interest rates in recent years, banks have been more inclined to finance transactions, and the financing conditions have remained favourable for funding investments in Swiss companies. Although rising interest rates and lower debt ratios may make it more challenging for private equity firms to secure financing for large acquisitions, borrowing conditions remain relatively generous. Investors exhibit considerable flexibility regarding transaction financing, as Swiss corporate law imposes only limited restrictions on a company's debt-to-equity ratio. However, from a Swiss tax-law perspective, de facto limitations exist due to thin capitalisation rules.

In the context of the security package provided in connection with a debt-financed transaction, it is crucial to adhere to the restrictions on upstream and cross-stream guarantees, as well as other security interests granted by the target to the parent or an affiliate (other than a subsidiary). At the time of signing, it is standard practice in Swiss transactions for the buyer to provide sufficient proof of funds, ideally in the form of a binding term sheet with the finance provider.

Regarding the equity portion of the purchase price, sellers typically request a customary equity commitment letter directly from the fund. However, such equity commitment letters are usually not to the direct benefit of the sellers but to that of the purchaser.

Traditionally, most private equity deals in Switzerland have been majority investments. However, given the current "investment plight," there is an increasing trend towards minority investments by private equity funds.

Over the past two years, M&A financing has significantly improved. Recently, access to debt financing has also seen notable enhancement, further supporting the anticipated rebound in private equity activity in 2024. The United States and European high-yield bond and leveraged loan markets are set to nearly double the amounts raised in 2023. In the first half of 2024, USD151 billion in high-yield bonds were issued, compared to USD176 billion for the entirety of 2023, while USD359 billion in leveraged loans were issued, compared to USD379 billion in 2023.

5.4 Multiple Investors

Club deals or syndicates of several private equity funds are primarily seen in larger transactions. In the context of private transactions, the parties have vast flexibility in structuring such club deals. The relationship among the club participants is in most cases governed by a shareholders' agreement.

In the context of public transactions, other rules apply to such co-investments, and the club participants are most likely to be qualified as acting in concert regarding the mandatory takeover rules (see also **7. Takeovers**).

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

The two predominant forms of consideration structures used in private equity transactions in Switzerland are the locked-box mechanism and the net working capital (NWC)/net debt adjustment as per closing. In the current (still) seller-friendly environment, a locked-box mechanism has been used in the majority of the transactions in order to give price certainty to sellers. However, the strongly influenced sellers' market in recent years, is seen to be slightly shifting towards a more balanced approach. Discussions which were not possible in the past few years – for example, regarding closing conditions or purchase price adjustments – have become more common again.

Earn-outs and vendor loans have been seen less often recently but are not uncommon. Given that, earn-outs especially are usually used in cases where the seller remains as an employee of the target company post-closing, in which case, however, certain restrictions from a Swiss tax-law perspective may apply.

6.2 Locked-Box Consideration Structures

Due to the current sellers' market, locked-box pricing mechanisms are often combined with an interest payment or cash flow participation, respectively, for the period between the locked-box date and actual payment of the purchase price (ie, closing), and buyers tend to accept longer periods between the locked-box date and closing.

Leakage, however, is typically not subject to interest and will be compensated on a Swiss franc to Swiss franc basis (unless considered permitted leakage).

6.3 Dispute Resolution for Consideration Structures

For locked-box consideration structures, it is unusual to have a dispute resolution mechanism in place because, in general, a one-off payment at closing is agreed, which has the effect that any leakage since the locked-box date is being considered and added to the consideration. Therefore, no additional dispute resolution mechanism is necessary.

Regarding completion accounts consideration structures, however, dispute resolution mechanisms are indeed common. Specifically, so-called appraiser mechanisms are agreed upon. If such a mechanism comes into use, a designated expert, mostly likely an auditing firm, determines the final and binding completion accounts and determines the adjustment of the purchase price in accordance with the respective agreement, if any.

6.4 Conditionality in Acquisition Documentation

The typical level of conditionality in Swiss private equity transactions is usually limited to the mandatory regulatory conditions, which are reflected in the transaction documentation as conditions precedent to closing. These typical regulatory conditions are approvals from regulating bodies; ie, a merger filing with the local competition authority, which evaluates whether the transaction would violate antitrust regulations, but also industry-specific regulations need to be considered; eg, licences in the pharmaceutical sector. Especially in transactions involving multiple jurisdictions, possible merger and foreign direct investment filings need to be taken into

consideration and might significantly prolong the period required to close after signing.

Depending on the transaction, it can be quite common to have further conditions such as financing or third-party consent. The latter in particular can be critical; eg, if the target has material agreements in place which are essential for the business and which contain change-of-control provisions, but the buyer has a strong interest in keeping such agreements in place, even after the transaction (eg, supply/customer or lease agreements).

Furthermore, material adverse change provisions, so-called MAC clauses, were quite often in use in the past; however, these have been used less lately. This is because sellers rarely accept these types of clauses in view of the transaction certainty in the current seller-friendly environment.

6.5 "Hell or High Water" Undertakings

In the current (still) seller-friendly market, with a high number of auction sales, "hell or high water" undertakings are often included in the merger clearance closing conditions.

6.6 Break Fees

In public M&A transactions, break fees are not uncommon, but are only allowed by the Swiss Takeover Board if the amount of the break fee is proportionate and if it serves the purpose of lump-sum compensation for damages and does not constitute an excessive contractual penalty. In any case, a break fee is not allowed to restrict shareholders significantly in their freedom to accept or not accept an offer and/or deter potential competing offerors. The amount of the break fees is in most cases significantly less than 1% in relation to the transaction amount. For private M&A transactions, however, break fees are an unusual instrument, since there are other mechanisms to keep the buyer indemnified due to a breach of contract. Reverse break fees are relatively rarely seen in private equity transactions since sellers often insist on actual financing proof.

6.7 Termination Rights in Acquisition Documentation

Usually, a private equity seller or buyer can terminate the acquisition agreement prior to closing if the conditions precedent to closing have not been met until a certain agreed date (ie, longstop date). A typical longstop date is often set at around 6–12 months from the date of signing, but it can vary depending on factors such as deal complexity, size, negotiations between parties, required regulatory approvals and other relevant considerations. Other than that, Swiss acquisition agreements typically do not contain any (ordinary) termination rights. However, under Swiss law, under certain conditions there is a possibility to terminate a share purchase agreement in the event of a severe breach of the agreement; any such termination right is usually – to the extent permissible – excluded as regards a breach of representations or warranties. In such a case of a termination, compensation for damages may be claimed.

6.8 Allocation of Risk

The typical methods for the allocation of risks are (i) representations and warranties for general (unidentified) risks and (ii) indemnities for specific risks identified during due diligence; eg, tax liabilities or pending litigation. In addition, with respect to risk allocation, there is a current trend towards so-called quasi-indemnities, which are representations and warranties that are excluded from disclosure and the general cap, but still subject to the other limitations, such as the notification obligation, de minimis, threshold/

deductible, damage definition, etc. In addition, risks can be allocated through the purchase-price mechanism as well as certain covenants.

Even though the details of risk allocation depend on the leverage and negotiating power of the buyer or seller, these methods are used regardless of whether the buyer or seller is a private equity fund.

6.9 Warranty and Indemnity Protection

The standard share-purchase agreements usually contain a catalogue of representations and warranties, covering the following (but not limited to those) areas: capacity, title to shares and corporate existence, shareholder loans, financial statements, ordinary course of business, material agreements, employment and social security, real estate, assets, environment, intellectual property, compliance with law, litigation, insurance and tax. In terms of limiting warranties, private equity sellers tend to limit these representations and warranties as much as possible while requesting buyers to take up a buyer policy W&I insurance.

With regard to disclosure of the data room, as a matter of principle, all information provided in the data room is considered as disclosed and therefore known, which is taken by the seller as an occasion to exclude any liability for what has been fairly disclosed.

In recent years, the use of warranty and indemnity (W&I) insurance in private M&A transactions has seen a significant increase in Switzerland. In the prevailing sellers' market, buyer-side policies are predominantly employed. These policies serve to bridge the "liability gap" when sellers are prepared to provide representations and warranties but seek to cap their liability at a level deemed insufficient by buyers. W&I insurance can augment the overall coverage available to buyers, thereby rendering transactions more agreeable for both parties.

6.10 Other Protections in Acquisition Documentation

As far as other protections go, indemnities for fundamental, business warranties and tax matters are extremely often provided by the seller. Depending on the actual wording of such indemnity clauses, these clauses are mostly designed as guarantees, which oblige the seller to indemnify and compensate the buyer fully for any damage, irrespective of the fault of the seller. It should be noted that, under Swiss law, the sole usage of terms such as "indemnification" do not constitute this effect. Whether the indemnity clause has an effect as a guarantee depends decisively on the formulation and design of the clause. Further, other kinds of guarantees – such as guarantees of a parent or group company, personal guarantee or bank guarantee – can be seen.

Furthermore, W&I insurances have been enjoying increasing popularity lately. However, such an insurance is subject to certain conditions, such as a positive due diligence. W&I insurances have another positive effect, in so far as a private equity bidder in an auction sale that would offer a W&I insurance might have a competitive advantage compared to other bidders, and therefore higher chances of winning the auction.

6.11 Commonly Litigated Provisions

While it is common that disputes in general arise from private equity transactions, it is rather uncommon that these disputes are litigated before ordinary courts or by arbitration. The Swiss approach for dispute resolution in connection with private equity transactions in general are settlements. However, in most cases it

is subject to a careful contract drafting to reflect potential conflicts in the contracts during the drafting process and to agree on dispute resolution mechanisms at an early stage.

The provisions from which most disputes arise are consideration mechanisms as completion accounts, consideration provisions and representations and warranties.

7. Takeovers

7.1 Public-to-Private

In recent years, the number of public-to-private transactions has been relatively limited, due to the lingering effects of the pandemic, geopolitical conflicts, and tight monetary policy in many countries, all of which have hindered a robust recovery of the global economy. However, given the large number of long-term commitments of private equity funds and the vast investments of private capital in public companies, we have started to see increased interest in public tender offers, including public-to-private transactions, some of which may materialise in the second half of 2024 or in early 2025.

In the context of a public-to-private Swiss M&A deal, the target company, a publicly traded entity, assumes a pivotal role as the acquisition target for the bidding party seeking to take it private. The target company's board of directors plays a critical function in assessing the acquisition proposal and acting in the best interests of the company and its shareholders. Their responsibilities encompass a thorough review of the acquisition terms, conducting due diligence, and engaging in negotiations with the bidder to ensure an equitable and advantageous outcome for the shareholders.

In buyouts of publicly listed companies, the key documentation to be prepared includes the following:

- a pre-announcement of the tender offer (public advertisement);
- an offer document outlining the offer to the shareholders of the target company; and
- a report of the target's board of directors.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

The Financial Market Infrastructure Act (FinMIA) provides for a number of thresholds that trigger a notification and disclosure obligation, in the event that a private equity fund (PE fund) (directly, indirectly or in concert with a third party) reaches, falls below or exceeds a certain percentage of voting rights in a listed company. The relevant thresholds are 3%, 5%, 10%, 15%, 20%, 25%, 33⅓%, 50% or 66⅔% of the voting rights in a public company, irrespective of whether they are exercisable or not. If these thresholds are met, the PE fund must then notify the company, as well as the competent disclosure office within four trading days.

It should also be noted that financial intermediaries who acquire or dispose of shares or acquisition or sale rights on behalf of third parties are not subject to this notification duty.

Furthermore, aside from the disclosure obligation concerning significant interests in listed companies, there is a specific notification requirement for non-listed Swiss companies. Any person, who alone or by agreement with third parties acquires shares in a non-listed Swiss company and thus reaches or exceeds the threshold of 25% of the share capital or voting rights, is obligated to disclose to the company the identity of the ultimate beneficial owner within one month

of the transaction. Failure to comply with this notification requirement within the one-month period will result in the suspension of membership rights, including voting rights, and forfeiture of monetary rights, such as dividend rights, until the required notice is provided.

7.3 Mandatory Offer Thresholds

Under Swiss law, a mandatory offer is to be made, when an investor directly, indirectly or acting in concert with third parties acquires equity securities which (together with the equity securities already owned (if any)) exceed the threshold of 33⅓% of the voting rights of the target company, whether exercisable or not. However, the shareholders' meeting of the target companies may either (i) raise this threshold up to 49% of voting rights – the so-called opting up – or (ii) decide that an offeror shall not be bound by the obligation to make a public takeover offer – the so-called opting out; both of these have to be reflected in the articles of association accordingly.

7.4 Consideration

In private M&A transactions, consideration may consist of either cash, shares, securities or a combination thereof. Cash settlements tend to be more frequent, as share deals are usually only accepted by the seller if the shares given as consideration are readily marketable (which would be the case with listed companies). Tax considerations also typically play an important role in determining the type of consideration that is eventually agreed upon.

For public M&A transactions, the consideration can also be paid in cash or in securities or a combination thereof. However, Swiss corporate and takeover law demands equal treatment of all shareholders, which imposes certain restrictions on the offeror. Offering cash consideration to specific majority shareholders while offering securities to minority shareholders would not be allowed. In mandatory and change-of-control offers (see **7.3 Mandatory Offer Thresholds**), the offer price must meet the minimum price rule. This rule requires that the offer price be at least equal to the 60-day volume-weighted average price (VWAP) if the stock is liquid, or the highest price paid for securities of the target company by the bidder(s) in the 12 months before the offer, whichever is higher. If the target shares are not deemed liquid from a takeover law perspective, the 60-day VWAP is replaced by a valuation to be provided by the review body. However, in partial tender offers or public tender offers for target companies with an opting-out provision in their articles of association, the minimum price rule does not apply, and the bidder is free to set the offer price (the best-price rule, however, applies).

In conclusion, the type of consideration accepted will in each case largely depend on the individual circumstances of the transactions; eg, the shareholders involved and their intentions or the type of transaction. However, cash consideration has historically been, and is still, more frequent than a consideration in securities.

7.5 Conditions in Takeovers

The permissibility of conditions that may be attached to a public takeover offer depends on whether it is a voluntary or a mandatory offer.

With respect to mandatory offers, the competent authority only deems a limited number of conditions permissible, in particular a condition that there are no injunctions or court orders prohibiting the transaction and/or that necessary regulatory approvals will be granted, as well as conditions ensuring the ability of the offeror to exercise the voting rights (ie, entry in the share register, abolishment of any transfer/voting restrictions).

Regarding voluntary takeover offers, the legal framework for conditions is more liberal, meaning that voluntary takeover offers may contain conditions which include minimum acceptance thresholds and no material adverse change (MAC) conditions. However, generally, it is not permitted for takeover offers to be conditional on the bidder obtaining financing, except for necessary capital increases in the bidder in connection with an exchange offer (*Umtauschangebot*).

The most common conditions are that the necessary approvals from regulatory bodies will be granted, such as merger control filings with the relevant competition commission, or other specific approvals from supervisory authorities in regulated sectors; eg, the bank or pharmaceutical sector.

7.6 Acquiring Less Than 100%

In a privately held company, a private equity buyer can, in general, secure additional governance rights by concluding a shareholders' agreement (eg, veto rights, the right to appoint the majority of the members of the board of directors or certain rights connected to dividends, as well as rights of first refusal, call options, drag-along rights, etc). The extent of the governance rights under a shareholders' agreement, however, is primarily subject to negotiations.

In a public company, the possibilities to conclude a relationship agreement are limited, because if the shares covered by the agreement constitute an aggregate participation of more than a third, the signatories would generally be considered as a group, which would trigger the obligation of a mandatory offer. Moreover, it is not always necessary to formalise the investors' influence further: depending on the shareholding structure; ie, if the structure is very fragmented with many shareholders, 30% of the voting rights may be sufficient to secure decisive control in the company.

Regarding a squeeze-out in a public company mechanism, under Swiss law an investor has two options:

- under the FinMIA, a bidder holding 98% of the voting rights of the company may, within three months upon expiry of the offer period, file for the cancellation of the remaining shares against compensation in the amount of the offer price to the respective minority shareholder in a statutory squeeze-out procedure before the competent court (*Kraftloserklärung*); or
- by way of a squeeze-out merger, if the bidder holds less than 98% but at least 90% of the voting right, against compensation in accordance with the Swiss Merger Act. The threshold to initiate a squeeze-out merger is lower; however, it carries a higher litigation risk than the cancellation procedure.

7.7 Irrevocable Commitments

Irrevocable commitments to tender shares are not enforceable under Swiss tender offer rules in case of a competing offer and the Swiss Takeover Board thereby establishes a level playing field for competing offers. According to Swiss takeover law, shareholders must be free to accept a superior competing offer.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Equity incentivisation of the management is very common in Swiss transactions since it is an extremely suitable instrument for retaining the management team in the long term and may also be attractive from a (Swiss) tax law per-

spective. Although the equity incentivisation of the management depends to a great extent on the individual transaction, the typical management stake varies between 3% to 10%. Ideally, management gets to invest on the same terms as the investor to provide even more attractive conditions to the managers (see also **8.2 Management Participation**). Furthermore, the individual structure of the management participation is very much tax-driven.

8.2 Management Participation

In Swiss transactions, there are two predominant structures for management incentive schemes: the "strip investments" and "sweet equity". In the case of the former, managers invest on the same terms and conditions as the financial investor, whereas in the case of the latter, managers receive a certain discount and/or different share classes. A sweet equity incentive scheme could, for example, be structured as follows: managers receive all ordinary shares while the financial investor receives a mix of ordinary shares and preferred shares with a fixed interest (or alternatively provides a shareholder loan). This leads to a certain envy ratio in favour of the managers. However, it should be noted that Swiss tax law sets rather narrow limits with respect to tax-exempt capital gains on sweet equity. To have "skin in the game" and to align fully the managers' interests with those of a financial investor, managers are generally asked to finance a substantial part of their investment with equity; ie, roughly 50% or more.

8.3 Vesting/Leaver Provisions

Equity participations of managers are usually subject to customary good and bad leaver provisions, which are mostly tied to the termination of the manager's employment or mandate agreement, or other events related to the manager personally (death, insolvency, divorce, etc). Leaver events typically trigger call/put options, whereby the leaver qualification has an impact on the purchase price (ie, in the case of a bad leaver, the purchase price is a lower percentage of the fair market value).

Vesting provisions, either time and/or performance-based, are also common practice in management participations. Vesting provisions may vary depending on the parties involved and the kind of leaver events that have been agreed. In practice, the most commonly seen arrangements involve time-based vesting with monthly or quarterly vesting over four years, a one-year cliff and end of vesting if the employment ends. The lapse of time together with the leaver event will then collectively have an impact on the purchase price (ie, portion of unvested shares are sold at a lower price versus portion of vested shared).

Furthermore, the parties often agree on a certain lock-up period (eg, three to five years) during which the manager may not transfer their shares and/or are limited with regard to the termination of their employment relationship (ie, a manager will be considered a bad leaver except in the case of a termination by the manager for good reasons or by the company without good reasons). After expiry of that lock-up period, the manager may also terminate the employment relationship without good reason and is still considered to be a good leaver. For the determination of a good reason, reference is usually made to the provisions of Swiss statutory employment law (Articles 340c and 337 of the Swiss Code of Obligations), indirectly including Swiss case law. Hence, a manager is typically considered to have good reason to terminate the employment relationship in the case of, for example, a material salary cut by the employer for no objective reasons or in the case of severe harassment at

work. No good reason would be attributed to the manager if, for example, the employer has delayed making a salary payment.

In addition, the breach of provisions of a related agreement also commonly triggers good and bad leaver provisions; eg, if the manager materially breaches an investment agreement, corporate regulations of the company, or their employment or mandate agreement, the manager will be considered a bad leaver.

8.4 Restrictions on Manager Shareholders

One of the most common restrictive covenants in Switzerland – which are part of the equity package and the employment contract – is the non-compete and non-solicitation undertakings during the time of the manager's investment and for up to three years thereafter. In particular, if the manager is simultaneously invested in the group as a shareholder and thus has various information and governance rights, a non-compete undertaking may be justified, even for the time after the manager has ceased to be an employee/director of the company.

However, based on Swiss statutory law, non-compete and non-solicitation undertakings may not exceed three years following the end of the employment relationship or the manager's exit as a shareholder. Further, they also need to be geographically limited as they otherwise would be considered an excessive undertaking on the part of the manager (eg, to the areas where the manager could harm the company with his or her knowledge). Excessive non-compete and non-restriction undertakings may be reduced by the court in the event that they are challenged, and the courts have broad discretion in doing so. The enforceability of non-compete and non-solicitation undertakings is often increased by stipulating contractual penalties for the manager or triggering bad leaver provisions in the case of a breach by the manager.

8.5 Minority Protection for Manager Shareholders

Managers who are not re-investing sellers generally have limited minority-protection rights. The most common minority-protection right is the right of the manager to participate on the same terms and conditions as the investor in an exit, which is ensured through drag- and tag-along rights.

However, depending on the negotiating power of management, additional minority-protection rights (such as veto rights, board-representation rights or anti-dilution protection) have been seen.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

The level of control of a private equity fund largely depends on the type of investment; ie, whether it invests as a minority shareholder or a majority/sole shareholder.

Typically, private equity shareholders taking non-control positions seek protection via restrictions of the transferability of the shares, tag-along rights, and put options, as well as certain governance rights, usually including the appointment of a representative on the board of directors and certain veto and information rights, which are, however, limited to fundamental rights with respect to the protection of their financial interest (dissolution, material acquisitions or divestures, capital increases, no fundamental change in business, etc).

In the case of a majority stake in the company, the private equity shareholder has extensive control over the company; ie, the majority in the board of directors and only limited restrictions due to veto rights to any minority shareholders. In addition, usually, protection rights regarding the shareholding of the company will be implemented (in particular, transfer restrictions, right of first refusal, and drag-along rights, as well as call options on the shares of the minority shareholders) to have maximum flexibility, in particular with regard to a possible exit.

9.2 Shareholder Liability

As a general principle, under Swiss law there is a separation between a company and its shareholders, and the shareholder may not be liable for the actions of the company.

However, according to case law, under special, limited circumstances the legal independence of the company and its exclusive liability are considered abusive and therefore unlawful, and consequently the controlling shareholder might be held responsible (piercing the corporate veil).

Further, a private equity investor or an individual acting for it may be considered as a de facto director of the company (eg, in the case of a material decisive operational influence) and, consequently, be bound by directors' duties as well as held responsible for possible damages resulting from a breach of those duties.

Lastly, a private equity investor that (solely or jointly) controls a portfolio company which has infringed competition law could be made jointly and severally liable for paying the resulting fine, as, 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.

10. Exits

10.1 Types of Exit

In private equity transactions, the exit strategy is a critical consideration, often assessed by investors prior to committing capital. The primary exit mechanisms for successful portfolio companies are trade sales and IPOs. These strategies may be pursued individually (single track) or in combination, structured as double- or triple-track processes. The double-track or triple track-track approach (simultaneously pursuing an IPO and a sale process), are significantly influenced by prevailing market conditions. When an IPO is contemplated, it is frequently accompanied by a trade sale (auction) process. However, a complete exit at the time of listing, involving the sale of all shares held by the PE seller, is generally not feasible through an IPO. Consequently, the PE seller must divest the remaining shares incrementally or through block trades.

10.2 Drag and Tag Rights

Drag rights or drag-along provisions/mechanisms are common in private equity transactions in Switzerland, as an investor typically wants to ensure that, in the case of an exit, potential buyers may acquire 100% of the shares in the target company, which increases the attractiveness of the sale. Hence, unless the potential buyer intends to continue (eg, with the investment of managers) the drag-along right will typically be utilised within the course of a transaction.

The threshold to trigger the drag-along mechanism usually relates to the shareholding of the investor but is usually at least 50%.

In accordance with the high frequency of drag-along rights, tag-along rights are also very common, especially for the management shareholders, while they are less common for institutional co-investors. As tag-along rights are typically subordinated to drag-along rights, and due to the fact that the retention of management shareholders will regularly be addressed at an earlier stage of the transaction, as well as in view of the deal certainty, the utilisation of such rights by the management shareholders is rather rare.

Even though it may depend on the leverage of the negotiating parties, the threshold to exercise the tag-along rights is usually also at least 50%.

10.3 IPO

On an exit by way of a Swiss initial public offering (IPO), the underwriters require sponsors and other large shareholders to enter into lock-up arrangements, usually for a period of six months after the IPO. For the company, its directors and managers, however, often a lock-up of 12 months is agreed. After the lapse of the lock-up, the sponsor will sell down shares, depending on prevailing market conditions pursuant to "dribble-out" trading plans or by way of accelerated book buildings or block trades to single buyers. Typically, such lock-ups are put in place for shareholders holding more than 3% of shares in the company.

While, in Switzerland, shareholders' agreements are typical and usually terminated upon the IPO, relationship agreements concluded post-IPO are quite unusual. Nevertheless, the conclusions of a few relationship agreements have been seen recently. Such arrangements may include board-appointment rights and joint sell-down or other "orderly market" arrangements.

Trends and Developments

Contributed by:
Beda Kaufmann and Alexander von Jeinsen
Advestra

Advestra is a corporate law firm located in Zurich, Switzerland. The firm advises clients on a broad range of M&A transactions, such as acquisition and divestment transactions (including corporate auctions), public takeovers, mergers, demergers, joint ventures, and financing rounds. It further advises on complex restructuring transactions and in situations of financial distress. Clients include private equity firms, public and private companies, sovereign wealth funds and other investors. The firm is also retained by entrepreneurs, growth companies and venture capitalists. Apart from corporate and M&A matters, Advestra advises clients on capital market transactions (both equity and debt), financing transactions, matters relating to financial services regulatory as well as tax. For practice not covered by Advestra, the firm relies on an extensive network of specialised firms.

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ADVESTRA

Market Activity

After record-breaking 2021 and 2022, overall deal volume for M&A transactions in Switzerland significantly dropped in 2023 and total deal value even came in at the second lowest amount of the last decade. Private equity transactions accounted for less than a quarter of all deals and none of the top ten transactions with a Swiss angle in 2023 by value had a private equity buyer or seller. Only two Swiss deals with private equity involvement edged past the USD1 billion mark in 2023 (per KPMG's Clarity on M&A 2024).

In spite of this overall lower level of activity, the Swiss market remained robust in the lower and middle markets, which are less dependent on raising financing in the international debt markets than large-cap transactions. In Switzerland, small and mid-cap transactions are often financed by Swiss banks. For larger transactions, private equity sponsors typically need to tap the international debt markets where private credit providers have been seen stepping in more frequently. The continuing rise of this asset class has been relevant for the private equity sector not only as a source of debt financing. It has also been a way for investment houses to expand the scope of their activities by growing their own private credit arms in parallel to their traditional buy-out funds.

Undoubtedly, the availability and cost of financing remains a major topic for private equity dealmaking as potential buyers of assets today are looking at very different deal economics than the sellers of these assets were looking at when they acquired them. Although the Swiss National Bank has cut interest rates in two successive instances this year as it deems inflation to be under control in Switzerland, many forecasts generally expect rates to remain at an elevated level for the foreseeable future. Therefore, the purported "end of the era of cheap money" and what that means for the private equity sector is also on top of dealmakers' agendas here. Not least because private equity dealmaking in Switzerland is to a large extent a cross-border affair and therefore heavily impacted by international developments.

Another topic in 2023 were increased requirements of the Swiss federal tax authorities for foreign private equity acquisitions. In many deals, private equity (PE) sponsors need to seek tax treaty eligibility for their acquisition structures for a reduced or zero-rate withholding tax on dividends paid by the Swiss target. This can be especially relevant to facilitate debt-servicing in the non-Swiss acquisition structure (often driven by the so called Swiss 10/20 non-bank rules) and to channel excess cash from Swiss group entities to more effective purposes. Such increased

requirements (especially for deals with a Benelux angle) include elevated substance standards and functions performed in the acquisition structure. It remains to be seen whether this will impact the level of deal activity in Switzerland or valuations for Swiss targets.

Interestingly, Deloitte's 2024 study on M&A activity of Swiss small and medium-sized enterprises (SME) has shown that while overall deal volume and value were down compared in 2023, which was to be expected, inbound activity into Switzerland has been hit particularly hard. Swiss SMEs have traditionally been attractive targets for non-Swiss sponsors. Therefore, a lack of Swiss SME inbound M&A activity is also indicative of subdued private equity dealmaking in Switzerland last year.

Looking ahead, while large amounts of dry powder are readily available to be deployed, the current fundraising environment is proving to be considerably more challenging for many GPs, not least due to fewer private equity exits recently.

Trends

There are fewer fully-fledged auctions in the Swiss market than in recent years, as potential sellers appear to be gauging the right time to bring their assets to market. For sought-after assets, however, auctions remain a popular exit strategy, and bidders are still willing to offer seller-friendly terms in order to secure the deal. From the buyers' perspective, pre-emptive bids continue to be an often-used tool in trying to gain an edge over competitors in such processes. On the other side of the spectrum, in line with a trend towards fewer auctions, there has been a tendency towards more protracted transaction timelines and more buyer friendly terms. While structured processes generally tend to accelerate the time to signing, one-on-one negotiations are more prone to delays, in particular when parties take more of a "wait and see approach" as a way of dealing with the current uncertainties regarding the economic outlook.

In the same vein, a significant part of private equity deal activity in Switzerland recently has been focused on implementing buy-and-build strategies around existing platforms. These transactions frequently involve targets in the smaller-cap segment of the market that are in turn often sourced on the basis of proprietary intelligence. The healthcare, software and professional services sectors are all examples of industries that have seen plenty of add-on transactions lately.

Parallel to the decline in auctions, there has been a discernible shift towards the use of continuation funds and so-called GP-led secondaries in the Swiss market. As is not uncommon for trends and developments in the private equity sector, utilisation of these structures appears to have been less prevalent in Switzerland than elsewhere initially. However, the popularity of these structures has certainly grown in recent months. This is considered part of a larger trend of GPs finding ways to return capital to LPs against a backdrop of a challenging exit environment.

In spite of the considerable interest that private equity houses have shown in taking Swiss-listed companies private both in 2023 and this year to date, only limited tangible deal activity has come from these efforts so far.

Meanwhile, IPOs are on the table again as a potential exit strategy for certain assets and there is certainly more activity in this space than a year ago. Galderma's IPO in March 2024 has been a successful point in case and others are

expected to follow later this year and next. Some sponsors have also been running dual-track processes in their efforts to find the optimal exit route.

Regulatory Environment and Legal Developments

UBS takeover of Credit Suisse

In March 2023, UBS and Credit Suisse signed a merger agreement following an intervention by the Swiss Federal Council, the Swiss National Bank and the Swiss Financial Market Supervisory Authority FINMA. In parallel, the Swiss Federal Council issued an emergency ordinance allowing for federal loss protection guarantees and liquidity assistance loans to be provided to UBS and Credit Suisse.

In the meantime, the merger has been consummated and the agreements regarding loss protection guarantees and liquidity assistance loans have been terminated by UBS, without taxpayer money having to be deployed. However, the merger of the country's two largest banks will of course remain a key focus of Switzerland's economy in many aspects. Notably from the private equity sector's perspective, it will be interesting to observe the merger's potential impact on the Swiss debt financing market and the Swiss M&A advisory markets.

Foreign direct investment control

Switzerland still has very limited restrictions on investments by persons from abroad. It has not yet introduced a comprehensive foreign direct investment (FDI) control regime and existing restrictions are currently confined to specific sectors such as residential real estate and the financial sector. Specific additional licensing requirements also apply to foreign investors in such sectors as aviation, telecommunications, nuclear energy and radio/television. However, Switzerland, mirroring recent international developments, has been actively pursuing the introduction of new FDI control legislation for some time. The Federal Council published a draft of the law in December 2023 after being tasked to do so by the Swiss Parliament which will deliberate on the draft in a next step. Interestingly, the Federal Council itself has so far been opposed to the introduction of new FDI control regulations, therefore the scope of application of the published draft is rather narrow compared to similar legislation in other jurisdictions. Specifically, the Federal Council maintains that it is not aware of any past transactions that would have jeopardised Switzerland's public order or national security. It will be interesting to follow further discussions on the topic as the legislative process advances in Switzerland against the backdrop of increasingly protectionist tendencies abroad. For now, the regulatory FDI environment in Switzerland certainly remains favourable for private equity investors.

Antitrust

In May 2023, the Federal Council published a revised draft for an amendment of the Swiss Cartel Act. It provides, inter alia, for a change in the substantive test applied by the Swiss Competition Commission (ComCo) in assessing whether to prohibit a transaction that is subject to merger control review. This means that the currently applicable CSDP (creation or strengthening of dominant position) test would be replaced by a SIEC (significant impediment of effective competition) test, which is in line with international practice. Importantly, however, the draft does not propose to lower the turnover thresholds that have to be met for a compulsory notification of a transaction to ComCo. These thresholds are rather high compared to international standards and therefore generally favourable from a dealmaking perspective.

Company law reform

A major reform of Swiss company law entered into force in January 2023. The reform addresses a wide array of topics and while many of these changes are not immediately relevant for M&A transactions, there are certain exceptions. Most notably, the delisting of companies now requires shareholder approval, with a qualified majority of two-thirds of the voting rights and an absolute majority of the capital represented at the relevant general meeting of shareholders being applicable. Given the typical acceptance thresholds in Swiss P2P transactions, this is not expected to make it more challenging for private equity investors to take Swiss-listed companies private.

The new law makes it easier for boards of directors to issue shares by introducing the concept of a capital band. It allows boards to increase or reduce capital within a range of between 50% and 150% of the issued share capital. The capital band is one of several ways the revised law aims to give companies more flexibility when it comes to share capital and dividends; another is the possibility of non-Swiss franc-denominated share capital. Further changes include a much-needed modernisation of the rules around shareholders' meetings and a stronger focus on companies' liquidity in the context of restructuring and financial distress.

ESG

In January 2022, Switzerland saw the introduction of new ESG regulations on non-financial reporting obligations as well as due diligence requirements in connection with child labour and minerals and metals from conflict areas. Whereas the former are only mandatory for larger listed companies and prudentially supervised large financial institutions, the latter have a broader scope of application. In principle, the new due diligence requirements are applicable to all natural and legal persons as well as business partnerships whose registered office, central administration or principal place of business is/are in Switzerland, and which carry out a trade. The regulations do, however, provide for certain exemptions, in particular for SMEs. Companies that fall under the scope of these new regulations had to comply with them for the first time in the financial year 2023. However, a number of companies have already been producing reports on non-financial matters on a voluntary basis for several years now as this is perceived as good corporate governance and viewed favourably by many investors.

Additionally, gender quotas for boards of directors and executive management were introduced on a "comply-or-explain" basis in January 2021. They will apply to most listed companies but are subject to transition periods of five and ten years, respectively. Swiss law also recently saw the introduction of disclosure duties for Swiss companies in the natural resources industry, which now have to disclose certain payments to government entities since the financial year 2022.

Of course, the breadth of topics that fall within the scope of ESG goes far beyond single legislative developments, and ESG considerations are expected to continue to be at the top of the private equity industry's agenda going forward for various reasons besides compliance with these regulations.

Outlook

The path ahead for private equity in Switzerland has certainly become more challenging in the course of the last years, as both financing issues as well as an uncertain economic outlook impacted dealmaking in general and private equity exits in particular. However, the Swiss

economy continues to be in good shape and the regulatory environment in Switzerland remains investor-friendly. It is therefore believed that private equity houses and their portfolio companies are well positioned to benefit from attractive investment opportunities as they continue to evolve and display the often-cited resilience that the private equity sector as a whole has become known for.

TAIWAN

Law and Practice

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Lee and Li Attorneys-at-Law is one of Taiwan's largest and most reputable law firms, offering comprehensive legal services performed by over 200 lawyers admitted in Taiwan and more than 200 accountants, patent attorneys and other professional personnel. The firm's professional and sophisticated legal practice has gained recognition from clients worldwide, leading to prestigious accolades. These achievements not only highlight the exceptional talent within the firm but also showcase its expertise across various legal domains, including energy law, M&A, banking and finance, capital markets, corporate matters and investment, data protection, TMT, intellectual property, real estate, dispute resolution and labour law. In recent years, the firm has also assisted renowned private equity funds in investing in domestic companies, financial institutions and the energy sector.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

2024 sees a modest recovery in private equity transactions and M&A deals in Taiwan, and this trend has continued into 2024. Following the pandemic, private equity funds are primarily focusing on the TMT sectors, but the overall momentum is still slow-paced. Transactions in the renewable energy industry are generally unaffected, with major divestments in offshore wind farms and new deployments in the solar and power storage businesses.

The authors have also seen outbound investments driven by local industrial giants through partnerships with private equity funds in response to regional economic growth. For example, Universal Scientific Industrial, a subsidiary of ASE Technology Holding, acquired TE Connectivity's Hirschmann Car Communication segment with Phi Capital. With extensive experience in capital markets and cross-border transactions, the private equity fund can assist Taiwanese industrial forerunners in business expansion, industrial integration, and future growth.

1.2 Market Activity and Impact of Macro-Economic Factors

Taiwan's robust manufacturing and R&D capabilities in semiconductors, 5G telecommunications, AI, and the internet of things (IoT) have positioned it at the heart of high-technology supply chains. The semiconductor and AI-related industries continue to attract investors despite the pressure of inflation and geopolitical uncertainty.

Geopolitical tensions across the strait are no longer an issue for sophisticated private equity funds when evaluating deals in Taiwan. Moreover, as the world's geopolitical landscape is reshaping, cross-strait tension, while a risk, is not so much of a deterrence for investors as long as countermeasures can be planned. Instead, the authors have seen investment trends shifting to Taiwan as a result of a tightened investment environment in neighbouring jurisdictions such as China and Hong Kong. Long-term investments in solar, offshore wind farms and power storage are active, as supported by governmental policies and green financing.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

To enhance the private equity investment environment, local stakeholders established the Taiwan Private Equity Association (TPEA) in 2023. TPEA members include private equity, securities, investment, venture capital, and other financial institutions.

As the authority in charge, the National Development Council (NDC) has promulgated the Guidelines for Facilitating Private Equity Fund Investing in Industries as part of the development of Taiwan's core strategic industries. These guidelines allow qualified private equity funds to solicit funding from insurance companies.

To join forces with the NDC, the Financial Supervisory Commission (FSC) also amended the Regulations on Outbound Investments by Insurance Businesses to loosen restrictions on insurance companies investing in core strategic industries through private equity funds. These regulatory changes have boosted investments by private equity funds in industries including green energy, biotechnology, intelligent machinery, and new agriculture.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Primary Issues Relating to Potential National Security Concerns

Taiwan regulates inbound investments by separating foreign or PRC investors through two different regimes, both reviewed by the Department of Investment Review (DIR) of the Ministry of Economic Affairs (MOEA). A foreign investor is generally permitted to invest in a Taiwan company unless the company engages in prohibited or restricted businesses. On the other hand, due to the political tensions across the strait, a PRC investor can only invest in a limited number of industries on the "positive list" published by the government. A PRC investor means (i) an individual, juristic person, organisation or any other institution of the People's Republic of China (the "PRC National"); and (ii) any company located in any third area (an area other than the PRC or Taiwan) (a) in which, in aggregate, more than 30% of its equity or capital is held by PRC National(s) or (b) which is controlled by PRC National(s).

If an investment involves a PRC investor or sensitive business (such as critical infrastructure, telecommunications business, or other restricted business), the DIR will request detailed information on the investor's shareholding structure and an explanation on the intended purpose, and seek relevant governmental bodies' opinions. In terms of private equity investments, the DIR will normally require the list of LPs (including its place of incorporation and source of funds). As the GP is responsible for making the investment on behalf of the fund/limited partnership, the DIR will also request the GP to disclose (i) the nationality/place of incorporation of each tier of investment vehicle, and (ii) the name and nationality of the respective shareholders and directors in each tier of investment vehicle, up to the ultimate beneficial owner(s).

The DIR approval is usually a condition precedent to closing. To this end, the detailed disclosure on the structure of the private equity fund may result in a protracted process, which could undermine the deal certainty and targeted timeline if not appropriately planned ahead.

EU FSR Regime for Private Equity Fund Transactions in Taiwan

The EU FSR regime mainly regulates "M&A activities of EU enterprises" and "participation in EU government procurement procedures", which may lead to distorted transactions in the EU market. Therefore, if a private equity fund transaction involves a Taiwanese target company operating in the EU and participating in the government procurement project, the parties will need to carefully assess the implications of the EU FSR regime.

Change in Law

There have been no significant legislative movements in anti-bribery, sanctions, and other related areas in the past year. In terms of ESG compliance, the Securities Futures Bureau (SFB) has recently issued the "Corporate Governance 3.0 – Sustainable Development Blueprint" to encourage public companies to improve their corporate governance and align with international ESG standards, such as the Task Force on Climate-related Financial Disclosure (TCFD) guidelines and Sustainability Accounting Standards Board (SASB) Standards.

4. Due Diligence

4.1 General Information

The level of legal due diligence will vary depending on whether it is a takeover or minority stake investment, and subject to factors such as the target's operation, the investor's risk appetite, and so on. In most instances, legal due diligence will entail a thorough examination of corporate, permits and approvals, real estate, material contracts, financial and liabilities, intellectual property, employment/labour, litigation, and insurances, with designated thresholds to filter the collected information/documentation. The work product could be a red-flag or full-blown report. For private equity deals, liability exposure in material contracts, financial and regulatory compliance are usually the primary focus.

4.2 Vendor Due Diligence

Vendor legal due diligence is quite often seen in the auction process, presented in the form of a high-level legal due diligence report, fact-book or similar documents to be provided to the bidders on a non-reliance basis so as to fast-track the due diligence conducted by the bidders and narrow down the potential issues. For example, the coverage of a vendor legal due diligence report in local energy deals is usually limited to corporate, licences, material contracts, and real properties.

5. Structure of Transactions

5.1 Structure of the Acquisition

Private equity acquisitions may involve minority stake investment, 50/50 joint venture structure, controlling stake, and equity buyout. The acquisition of a minority stake can be made through a sale and purchase agreement. Merger, share swap, share exchange, and tender offer are often seen in takeover or equity buyout deals.

Court approval is not required in the deal structures mentioned above, but foreign or China investors must obtain approval from the DIR. Private equity funds tend to tailor their acquisition strategies and conditions based on the deal size, industry, and the target company's ownership structure.

In auctions, the seller will lead the process and will have more bargaining power on the transaction terms and conditions. On the other hand, privately negotiated transactions require more flexibility in dealing with multiple stakeholders, such as the seller(s), management team, and key employees, usually leading to a longer time frame and additional costs.

5.2 Structure of the Buyer

Private equity funds usually make their investments in Taiwan through multiple layers of entities, such as an offshore joint venture/consortium or special purpose vehicles (SPV), in order to mobilise funds, manage portfolios, minimise liability exposure, and facilitate a clean exit.

In the event the transaction is conducted through a bidco or SPV, the private equity fund is typically not included as a party to the transaction; nonetheless, the fund will issue a letter of intent, parent guarantee, or equity commitment letter to satisfy different needs when consummating the transaction.

5.3 Funding Structure of Private Equity Transactions

Subject to the deal size, investor appetite, and target industry, private equity deals can be financed in the following ways.

- Project finance, where a project company seeks medium- or long-term loans from banks, relying on the expected returns of the specific project. This is often seen in infrastructure investments such as offshore wind farms in Taiwan.
- Leveraged buyout, where the private equity-based buyers obtain funds from bank loans secured by the target's asset/shares or expected returns.
- Management buyout, where the target's management team acquires the company from the shareholders with the management team's own funds, debt financing from banks, and/or financing from private equity funds.

An equity commitment letter from the shareholders of the buyer SPV is sometimes required to show that the SPV has sufficient funds to complete the deal. If the funds will come from loans, the transaction documents may include an agreed form for the finance documents and/or a request for relevant representations on the execution of these documents. In such cases, the financial close (including the fulfilment of all conditions under the finance documents) will often be the condition to closing the deal to ensure a seamless closing on the equity side.

5.4 Multiple Investors

In Taiwan, it is not uncommon for investors (such as institutional or strategic investors) to form a consortium with private equity funds to sponsor the deals. The consortium can be structured by forming an SPV onshore or offshore. For example, Orsted brought in a consortium of CDPQ and Cathay PE as co-investors in the 605.2 MW offshore wind farm Greater Changhua 1. In 2023, Phi Capital and Universal Scientific Industrial, a local electronics company, joined forces to acquire TE Connectivity's Hirschmann Car Communication segment. This deal combined the corporate investor's industrial knowledge with the private equity fund's finance and management strength, achieving synergies in various aspects.

For deals with a larger number of investors, the consortium can also be set up through a limited partnership or similar fund structure. Multiple LPs can be passive investors who generally defer investment decisions to the GP and the investment committee.

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

For private equity transactions in Taiwan, consideration structures may vary depending on factors such as whether the target company is publicly listed or private, the valuation gaps between the buyer and seller, and the volatility of the target's industry, and they are often heavily negotiated by the parties.

A private equity seller typically prefers consideration mechanisms without post-closing adjustments or contingent arrangements – eg, fixed price with or without locked box (especially in a public deal) so as to achieve a clean exit. On the contrary, a private equity buyer may seek for price adjustments such as completion accounts, earn-outs, or deferred consideration to ensure the purchase price closely reflects the underlying valuation/financials.

Rollover is a preferred way to consolidate the target company's shareholding structure, align the management team objectives with the investors, and reduce the cash outlay or unnecessary limbs in the shareholding structure. For consideration mechanisms without any setoff against

post-closing price adjustment or deferred payment, protection in the transaction largely depends on warranty and indemnity insurance if private equity funds are involved.

6.2 Locked-Box Consideration Structures

Fixed price locked-box consideration structures are preferred in private equity-backed acquisition of public companies in Taiwan. These are not uncommonly seen in private transactions where private equity funds wish to exit. In the experience of the authors, the parties would usually not otherwise charge (reverse-) interest for any leakage that occurs during the locked-box period, but this can be subject to the parties' negotiation in each case.

6.3 Dispute Resolution for Consideration Structures

A dedicated expert (often an independent CPA firm) is essential especially when a completion account, earn-outs or a deferred consideration mechanism is adopted in the deal. If the parties fail to reach a consensus on the financials or basis of calculation, the pre-agreed third-party expert will step in and the determination thereof will be binding on both parties.

If the dispute remains unresolved or either party attempts to dispute the decision from the dedicated expert process, the general dispute resolution outlined in the transaction documents will then apply either through litigation or through arbitration.

6.4 Conditionality in Acquisition Documentation

In local private equity-backed transactions, it is not uncommon to have conditions other than mandatory and suspensory regulatory conditions, such as corporate authorisations, financing, third-party consents, shareholder approval, satisfactory due diligence, and no material adverse event (MAE).

Third-party consent is usually required in the event that the transaction will trigger the change of control clauses in the facility agreements with the banks or material contracts with top customers or suppliers, in order to avoid the risk of breach under such agreements that may compromise the target's usual or expected business operations.

An MAE clause is also considered a fairly standard inclusion in private equity transactions. Whether to adopt a qualitative or quantitative threshold will largely depending on the target's industry/business and the result of negotiation.

6.5 "Hell or High Water" Undertakings

From the authors' observations, risk-averse private equity buyers tend to avoid a "hell or high water" undertaking which imposes heavy burden on the buyer side to complete the deal, especially considering the increased regulatory uncertainty in recent years. In practice, a "hell or high water" undertaking will involve obtaining regulatory approvals such as foreign investment approval, antitrust clearance and, where the targets are in highly regulated fields (such as the telecommunications and financial industries), ad hoc approval from the competent authorities.

The new EU FSR may come into play for Taiwanese targets participating in public projects in the EU. Therefore, when structuring the deal, the parties will need to carefully negotiate these types of undertakings in terms of the required approval for completion or any potential conditions that may be imposed by the authority to enhance the deal certainty.

6.6 Break Fees

A break fee in favour of the seller may not be prevalent in deals with a private equity-backed buyer. However, these arrangements are sometimes used in cross-border public transactions or auctions as a deal protection mechanism. In highly regulated industries such as banking, insurance, or financial holdings, break fee arrangements may incite the regulator's oversight and prolong the review process.

Based on the authors' observations, a typical trigger for the break fee or reverse break fee is tied to the failure to obtain key governmental/regulatory approvals in the relevant jurisdictions. The break fee can range from 1% to 5% of the total purchase price, whereas the reverse break fee can be 1.5 to 2 times the break fee. The specific amount and conditions will still be determined through negotiations between the parties.

6.7 Termination Rights in Acquisition Documentation

Private equity deals may be terminated due to the following circumstances:

- occurrence of a material adverse event;
- failure to obtain shareholders' approval;
- deal prohibited by applicable laws or by the authorities; or
- failure to fulfil the conditions before the longstop date.

The longstop date generally aligns with the expected timeline to fulfil the condition precedents agreed upon by the parties, especially for obtaining the necessary governmental/regulatory approvals for the deal, with a certain buffer built in for prudence. In general, a standard foreign investment approval involving a PE investment in non-highly-regulated industries might take at least two to three months, so the longstop date would typically be five months or longer from the signing, subject to adjustments in view of the merit in each case.

6.8 Allocation of Risk

A private equity seller may seek to shift the operational risks of the target company to the buyer or other sellers given that a private equity seller usually provides limited representations and warranties without exposing itself to any contingent liabilities. On the other hand, a corporate seller involved in the day-to-day operations and business decisions usually will be requested to undertake comprehensive representations and warranties on the general business operations of the target company.

In case of a private equity buyer, the warranty and indemnification insurance could be used to externalise potential risks, especially when the disclosures collected from due diligence are limited.

6.9 Warranty and Indemnity Protection

Typically, a private equity seller will offer rather limited warranties and indemnities with customary limitations of liability, such as liability period, de minimis, tipping/spilling liability basket, liability cap, matters disclosed, and/or claims arising from the buyer's acts or omissions.

When the management team also sells their stakes in the target company, the management will usually provide operation-related representations and warranties. To ensure a consistent standard in the transaction documents, the private equity fund's limitation on liability is generally extended to the management team. In addition, directors' and officers' insurance is a common risk management tool used to insulate the management team from financial losses.

When the buyer is backed by private equity, the buyer will request comprehensive warranties and indemnities to align with their prior deals and risk tolerance. Nonetheless, the terms will usually be open to negotiation in each case.

While a general disclosure of the data room is acceptable for affirmative disclosures in representations and warranties, it is typically not allowed for negative disclosures, as the scope of exception could be too broad or vague. In practice, negative disclosures against, or as exceptions or qualifiers to, the representations and warranties should be made specifically.

Overall, limitations on liability for warranties or indemnities in Taiwan generally follow the practices in the US or EU market, given that US or EU-based private equity funds have played an important role in the past private equity activities.

6.10 Other Protections in Acquisition Documentation

Warranty and indemnity insurance is also preferred in private equity transactions. In addition to the general fundamental and business warranties and representations, tax liability insurance (TLI) can be procured to address potential tax liabilities identified during the due diligence process or associated with the general business operations of the target company.

On the other hand, an escrow or retention could be rarely seen in private equity exit transactions which might defeat the purpose of exit.

6.11 Commonly Litigated Provisions

Litigation could be scarce for private equity transactions, as the parties will usually try to resolve disputes in a more expedited manner to avoid a protracted litigation timeline and burden on costs. If the parties cannot resolve the dispute via commercial negotiation, private equity funds tend to opt for arbitration over court litigation, considering arbitration is a non-public procedure with higher confidentiality and flexibility.

In Taiwan, disputes could arise from consideration mechanics, valuation gap between the parties, scope and limitations on warranties, indemnities, or dissenting shareholders exercising the appraisal rights for share buyback.

7. Takeovers

7.1 Public-to-Private

Public-to-private deals involving private equity-backed bidders have become increasingly common in Taiwan in recent years. Such take-privates are often initiated by tender offers.

The target company will, within 15 days after receiving the tender offer from the bidder:

- establish a special review committee to review the fairness and reasonableness of the tender offer conditions;
- report to the FSC; and
- announce the tender offer and the comments of the board and special review committee to the shareholders.

The board of the target company has a fiduciary duty to its shareholders. Therefore, it is rare for the target company to enter into an agreement with the bidder on the tender offer, as such agreement often obligates the board to support the tender offer. An agreement signed between the bidder and the target company would be subject to mandatory disclosure prior to the launch of the tender offer.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Shareholding Disclosure Thresholds

Any person who, either individually or jointly, acquires more than 5% of the total issued shares of a public company must report to the FSC. Any change in the shareholder's shareholding of 1% or more of the public company's total issued shares should also be reported. The directors, supervisors, managerial officers and shareholders holding more than 10% of the public company's total issued shares are also subject to regular reporting obligations.

Tender Offer Disclosures

A bidder should first submit the tender to the FSC and make a public announcement of the tender offer, including the following information:

- basic information on the bidder;
- terms and conditions of the tender offer;
- type and funding source of the purchase price for the tender offer;
- risks of participation and non-participation in the tender offer;
- status of the bidder's shareholding in the target company;
- any agreement concerning the tender offer signed by (i) the bidder, and (ii) the target company, its management team, or shareholders within two years before the filing of the tender offer (if any);
- the bidder's business plan for the target company;
- the bidder's board resolution; and
- fairness opinion on the purchase price.

The bidder should report to the FSC and announce publicly the results of the tender offer within two days after the expiry of the tender offer period.

The above disclosure obligations apply to all bidders of a tender offer, regardless of a private equity-backed bidder.

7.3 Mandatory Offer Thresholds

A mandatory tender offer is triggered if anyone, alone or in concert with others, plans to acquire 20% or more of the issued shares of a public company within 50 days unless any exceptions apply. An acquisition will be deemed in concert with others if the acquirers acquire such shares by means of a contract, agreement, or other form of agreements for a joint purpose.

7.4 Consideration

In general, cash is more commonly used as consideration in M&A transactions in Taiwan. In a tender offer, if the consideration is in cash, a performance guarantee from a financial institution or a written confirmation from a qualified financial adviser or CPA must be included in the offer documents as proof of funding. If the consideration is in the form of shares, such shares must be (i) domestic securities traded on the Taiwan Stock Exchange or the Taipei Exchange or (ii) foreign securities prescribed by the FSC.

In practice, the tender offer price is usually above the market price to incentivise the shareholders to tender their shares. An independent expert's fairness opinion is generally required, and the directors of the companies participating in the transaction must fulfil their fiduciary duties by reviewing and negotiating reasonable terms and conditions.

7.5 Conditions in Takeovers

In practice, common conditions of a tender offer are (i) the threshold for the tender offer and (ii) the required regulatory approvals.

A tender offer conditioned on the bidder obtaining financing is generally not permissible. A bidder should disclose details of its funding source for the consideration, substantiated by relevant supporting documents, in the tender offer. Moreover, a bidder cannot withdraw or cease a tender offer once it is launched unless approved by the FSC due to any of the following events:

- the bidder has proven a material change to the financial or business conditions of the target company;
- the bidder is subject to bankruptcy or reorganisation, death, or being declared incompetent; or
- other reasons specified by the FSC.

In practice, a bidder often seeks the principal shareholders' commitments to vote for the deal at the shareholders' meeting and to tender the shares. Whether to request further deal security provisions (such as break fees, match rights, force-the-vote provisions, non-solicitation, etc) will be subject to the parties' negotiation. In the event that the principal shareholder is also a director of the target company, a fiduciary-out provision will often be included.

7.6 Acquiring Less Than 100%

The Taiwan Company Act prescribes a set of matters requiring a majority (majority vote from at least 1/2 quorum) or supermajority (majority vote from at least 2/3 quorum) approval at a shareholders' or board meeting. Moreover, except for the voting agreement among the shareholders during the deal process, the Company Act generally prohibits shareholder voting agreements on a public company's governance matters. Hence, except for the shareholders' rights prescribed by the law, the minority private equity bidder generally has no governance rights over the target company by a shareholders' agreement.

A private equity-backed bidder may not be able to achieve a debt push-down following a successful offer, as a public company is bound by stringent financial and accounting rules as well as governance requirements.

In practice, take-privates in Taiwan may be implemented through a two-stage process – (i) the bidder acquires over a certain level (such as two-thirds) of the shares via tender offer and (ii) a back-end merger or share swap between the bidder (or its vehicle) and the target company. The minority shareholders will be squeezed out as a result of the second step merger or share swap. In such case, dissenting shareholders may exercise their statutory appraisal right against the target company for the court to adjudicate the fair market value of the shares being cashed out.

7.7 Irrevocable Commitments

While the courts of Taiwan do not deem all voting agreements to be valid, the Business Mergers and Acquisitions Act allows shareholders to enter into a written agreement on the joint exercise of their voting rights and related matters when a company enters into a merger or acquisition. In practice, agreements under which the major shareholders commit to vote in favour of the deal at the shareholders' meeting and to tender shares are common. Negotiations on such agreements and transaction documents are usually undertaken concurrently. The undertakings usually include irrevocable commitments to tender or vote by principal shareholders of the target company, typically contingent on obtaining approvals of the board meeting and/or competent authorities. However, the manager

shareholders would require a fiduciary-out if a better offer is made.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Offering equity incentives to management teams can be considered a common practice in Taiwan, with the Company Act and the Securities and Exchange Act providing the necessary framework for implementation. Either the Taiwanese company or an offshore holding company may provide equity incentives to streamline the holding structure.

Equity incentives are typically implemented after the transactions, tailored to and rolled out as per the specific needs of the private equity. The options available for equity incentives, as prescribed under the Company Act and the Securities and Exchange Act, include profits distributed as shares, employee treasury stocks, employee stock options, and restricted stock units. Additionally, companies may negotiate phantom stock arrangements with their employees.

For stocks issued by an offshore holding company, in general, the offering of securities issued by an offshore company under a global omnibus employee stock option plan to specific employees in Taiwan will not be deemed an offering to non-specific persons, which is exempted from the regulations on public offerings and issuance of securities.

8.2 Management Participation

In management buyout (MBO) transactions, the current management team of a company buys out a majority of the shares from existing shareholders to gain control of the company. When the MBO involves the direct purchase of issued shares, management will less likely face conflict of interest. However, if the MBO involves a share swap, directors who are also the purchasers may need to disclose their conflict of interest.

In Taiwan, preferred stocks are permitted under the Company Act and can be structured with various rights, including dividend, voting, and veto rights. In practice, private equity investors often use preferred stocks to limit the management shareholders' rights, such as by restricting voting and dividend distribution rights. Additionally, sometimes the management team may only sell their shares upon exit along with the controlling shareholders.

8.3 Vesting/Leaver Provisions

Vesting provisions for equity incentives are common in Taiwan, and companies have the flexibility to design arrangements for any stock options and RSUs. The Company Act is generally silent on restrictions attached to stock options or RSUs, allowing issuers to determine the relevant terms and conditions. Vesting periods and other restricted rights, such as restrictions on share transfer, voting rights, dividend rights, and/or share withdrawal, are generally permitted as long as they are stipulated under the terms and the conditions and approved by the board of directors of the issuer and related committees (if applicable).

Issuers have the freedom to set vesting and performance conditions for stock options or RSUs based on their objectives and reward plans. Different vesting conditions or issuance prices may apply for the same round of stock options or RSUs. If an employee fails to meet the vesting conditions, such as being disqualified or leaving the company, the issuer may reclaim or repurchase the outstanding stock options or RSUs in

accordance with the relevant terms and conditions.

8.4 Restrictions on Manager Shareholders

It is common practice for management shareholders to enter into restrictive covenants with the company. Typically, standard non-compete, non-solicitation/poaching, non-disparagement undertakings, and non-dealing covenants are included in equity packages or employment contracts.

In Taiwan, aside from post-employment non-compete clauses, restrictive covenants should not be subject to excessive restrictions. Article 9-1 of the Labour Standards Act provides that the period, area, and scope of occupational activities limited by the post-employment non-competition clause should not exceed a reasonable range. Particularly, employers must have legitimate business interests that require protection, and a post-employment non-compete period should not exceed two years.

An employer is also required to provide reasonable compensation to the employee for complying with a post-employment no-compete clause. The monthly compensation should at least be one-half of the employee's monthly wage upon departure, as stipulated under the Enforcement Rules of the Labour Standards Act.

8.5 Minority Protection for Manager Shareholders

The rights of management shareholders are often restricted as private equity investors prefer not to provide management shareholders with the same level of protection afforded to key minority shareholders. In practice, the voting rights, dividend distribution rights, and the exit rights vested in the preferred shares held by management shareholders may be limited to the fullest extent permitted by law.

Notwithstanding the above, the Company Act provides a minimum level of protection for preferred shareholders. Any amendment to the Articles of Incorporation that is detrimental to preferred shareholders is subject to approval by a special resolution at a preferred shareholders' meeting; such protection cannot be contractually waived.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

A private equity shareholder typically requires the following rights to ensure control over its portfolio companies.

- Board appointment rights under which the shareholder can appoint a specific number of director(s) to the board.
- Supervisor appointment rights for the shareholder to appoint a supervisor for the portfolio companies.
- Information rights relating to the periodical financial information of the portfolio companies and any other specific operational information on a case-by-case basis.
- Shareholder reserved matters, such as any change to the preferred shareholders rights, redemption of preferred shares, change to the capital or board seats of any portfolio companies, liquidation of any portfolio company, among others. The shareholders may also set a higher voting threshold on the reserved matters. However, if the shareholders intend to stipulate higher quorum/voting requirements in the company's articles of incorporation (AOI), the MOEA's latest view is that

this is only allowed for reserved matters that are explicitly permitted under the Company Act. Hence, when formulating the reserved matters to be incorporated in the AOI, shareholders should ensure compliance with the Company Act.

9.2 Shareholder Liability

A shareholder of a company limited by shares is generally liable for the company up to the amount of share capital it has subscribed to. Nonetheless, the corporate veil will be pierced if the shareholder abuses the limited liability protection and causes the company to incur debts it cannot repay. In the event a private equity-backed major shareholder causes a portfolio company to engage in abnormal business operations, the controlling company will be liable to compensate the portfolio company for such losses. A private equity fund backing the majority shareholder would generally not be held liable for the actions of its portfolio company unless the corporate veil is pierced under exceptional circumstances.

10. Exits

10.1 Types of Exit

Private sales, auction sales, and IPOs remain the most common ways for private equity funds to exit. The exit strategies vary depending on the milestones achieved, the expected financial return, the stakes owned by the private equity investor, maturity of the target company and its industry, and the inclination of other shareholders.

While multiple exit plans will be evaluated at the outset, a single process will be implemented as multiple tracks running in parallel may lead to a longer deal timeline, involve different levels of regulatory reviews (competing with each other), incur additional expenses and weaken the deal certainty.

It is rare for private equity sellers to roll over or reinvest upon exit; nevertheless, private equity sellers may sometimes reinvest through private investment in public equity (PIPE) to provide funding to the portfolio and to subsequently sell the shares on the market.

10.2 Drag and Tag Rights

Drag rights and tag rights are common features in private equity deals. However, such rights are not often enforced in practice because the investors normally prefer to act in concert when there is an opportunity to exit.

The exercise of drag rights is usually conditional on the sale of controlling or up to 100% of the target's share, sometimes with a valuation floor. When the private equity fund only holds a minority stake, the drag right is still heavily negotiated, aiming to allow the private equity to drag other founder/management shareholders or co-investors to better its chances of exit.

The common threshold for tag rights is the disposal of more than 50% of the target's shares by the controlling shareholders. Minority financial investors often request tag rights to protect themselves against a change of control that could result in a change in management. As for founder/management shareholders, the tag right may be limited by their incentive schemes as tag rights go against the purpose of the incentive scheme.

10.3 IPO

According to the IPO-related rules, major shareholders (ie, those holding more than 10% of the company's total issued shares) are subject to

a lock-up period of at least six months, which may be extended to up to two years. Post-IPO relationship agreements between private equity sellers and the target are rare. In recent years, overseas IPO via de-SPAC has become a popular way of private equity exit due to the reduced time and cost compared to traditional IPOs.

Trends and Developments

Contributed by:
Lihuei Mao (Grace), Derrick Yang, Rose Huang and Yu-Ting Su
Lee and Li Attorneys-at-Law

Lee and Li Attorneys-at-Law is one of Taiwan's largest and most reputable law firms, offering comprehensive legal services performed by over 200 lawyers admitted in Taiwan and more than 200 accountants, patent attorneys and other professional personnel. The firm's professional and sophisticated legal practice has gained recognition from clients worldwide, leading to prestigious accolades. These achievements not only highlight the exceptional talent within the firm but also showcase its expertise across various legal domains, including energy law, M&A, banking and finance, capital markets, corporate matters and investment, data protection, TMT, intellectual property, real estate, dispute resolution and labour law. In recent years, the firm has also assisted renowned private equity funds in investing in domestic companies, financial institutions and the energy sector.

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Overview

The growth and development of private equity funds in Taiwan have evolved over time. In the past, offshore private equity funds, particularly those from international firms, dominated both in terms of deal number and fund size. With the tightening of cross-strait relations, investments by PRC private equity funds in Taiwan are subject to more stringent scrutiny and scaled back. In the past five years, Taiwanese government policies have encouraged the set-up of local private equity funds, which are making their presence felt in local deals through investments in infrastructure, renewable energy, semiconductor and other technology sectors.

Recent Development

Influences by the global economic environment

In 2022, global private equity fundraising experienced a downturn, mainly due to the uncertain economic outlook. Both the number of investment deals and the total amount of money raised are on the decline. The withdrawal of global capital and decreasing corporate valuations have affected market activities. Taiwan is not immune from the global downturn, and tensions between China and Taiwan have led to a more cautious attitude shared by offshore private equity funds, which resulted in a decline in the overall number of private equity-backed deals in Taiwan.

Market outlook

Owing to market uncertainty and volatility, certain investors are seizing disruptive investment opportunities to invest in new markets or businesses to strengthen their market position, while other investors are scaling back their investments in Taiwan and concentrating on internal restructuring and transformation to other higher-yield potentials. Notwithstanding the headwind and challenges, a modest recovery in private equity transactions and M&A deals is expected in 2024. Semiconductor and AI-related industries continue to attract investors' attention. Transactions the in renewable energy industry also carry a positive momentum.

Key industries for private equity investments

In recent years, private equity investments, both inbound and outbound, have been highly concentrated in the following areas in Taiwan.

AI and semiconductor supply chain

The rapid advancement of AI technology, in combination with Taiwan's leading R&D technologies in the semiconductor industry, has made Taiwan uniquely positioned in the global semiconductor supply chain. Taiwan's strengths in innovations and production capabilities become essential for the development and deployment of advanced AI systems.

With the support of a robust infrastructure, skilled workforce, and government policies, Taiwan has bolstered its position as a global leader in these sectors. Both domestic and international investors, as well as private equity firms, are increasingly investing in Taiwan's AI and semiconductor supply chain, including IC design, manufacturing, data centres, servers, and cloud computing, and reshaping their investment strategies to align with the expansion and integration of supply chain.

While there has only been a fairly limited number of larger-scale M&A in the past two years, the market is not short of small and medium-sized acquisitions and investments. These collaborations reflect a robust and dynamic investment environment that is driving growth of AI and semiconductor supply chain into the next phase.

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Offshore wind and green energy

The green energy sector remains a key focus for both international and local private equity funds, driven by the increasing emphasis on environmental, social, and governance (ESG), sustainable and responsible investment. In recent years, Taiwan's Ministry of the Environment has passed major policies that favour green energy developments. One such policy is the amended Climate Change Response Act (2023), which explicitly encourages the government to pursue climate change deterrence measures such as promoting green technology and encouraging a circular economy. The shift towards environment-friendly investments reflects the growing global focus in this area.

In Taiwan, offshore wind farms and energy storage equipment are among the top priorities for investments. Offshore wind development began in 2018 with small-scale pioneer projects and sped up in the Round Two auction. With a number of wind farms which have already reached commercial operation and undergone divestments by the sponsors to other investors, the Ministry of Economic Affairs has launched a Round Three auction for further developing 10 GW capacity until 2035.

With respect to the investments in solar energy storage equipment, in October 2023, Taiwan Power Company announced the suspension of dReg and E-dReg grid-connected investment applications in the energy storage industry. The decision was due to an overwhelming number of applications, leading to market saturation. The influx of operators in a short period of time may result in low-capacity fee bidding, thereby negatively affecting long-term investment returns. Nevertheless, the demand for growth and development in this sector is apparent.

Biotech and healthcare

Taiwan's biotech and medical sectors have also been attracting significant interest from private equity funds due to R&D capacity and advanced industry clusters. A notable example is Baring Private Equity Asia's acquisition of Ginko International Co., Ltd., which is one of the largest privatisations in Taiwan involving an international private equity fund in recent years. This landmark transaction not only highlights the attractiveness of Taiwan's biotech and medical sectors, but also paves the way for similar investments in the future. The transaction also showcases the potential for Taiwan to become a hub for medical and biotech innovations in the Asia-Pacific region.

Automotive and electric vehicles

The automotive and electric vehicle industries have been aggressively expanding into the field of green energy and electric bus technology and manufacturing. This shift is driven by the pressing need to reduce carbon emissions and combat climate change. As a result, these industries have drawn increased attention from investors and private equity funds. Additionally, the government's climate-friendly policies are steering public transport to electric power. This will lead to significant private equity investments in relevant projects. For instance, in 2023, Universal Scientific Industrial, a subsidiary of ASE Technology Holding, acquired TE Connectivity's Hirschmann Car Communication segment with Phi Capital. This deal clearly demonstrates that private equity funds can assist Taiwanese industrial forerunners in business expansion, industrial integration, and future growth.

Legislation Efforts

In recent years, legislative efforts have fostered a more favourable environment for local private equity investments.

PE Guidelines promulgated in 2021

The promulgation of the "Guidelines for Promoting Private Equity Fund Investments in Industries" (the "PE Guidelines") is a milestone in the establishment of regulatory standards for private equity funds in Taiwan. The National Development Council (NDC) promulgated these PE Guidelines to help qualified private equity funds obtain support from the insurance industry and other funding sources more easily.

Requirements for private equity funds

The PE Guidelines outline the requirements for private equity capital size and professional standards: (i) the total amount of the company's or the limited partnership's contractual capital contribution must be at least TWD1 billion, and (ii) the private equity must be managed by a team of three or more professionals with expertise in the management of equity funds or the investment industry. These professionals should be capable of evaluating potential target businesses, making informed investment decisions, and conducting post-investment management.

Significant strategic industries

The significant strategic industries in which the private equity funds can invest include (i) information and digital services, information security, precision health, national defence and strategy, green energy technology, public welfare and defence, Asia Silicon Valley, biotechnology and medicine, intelligent machinery, recycling or circular economy, new agricultural industry, (ii) forward-looking infrastructure projects, (iii) infrastructure, (iv) industries needing upgrading or restructuring, and (v) any other industries identified by the central government authority for purpose-built businesses as being in line with policy direction.

The NDC has designated a wide range of strategic industries suitable for private equity investment with the aim of significantly expanding the sources of private equity capital and actively fostering overall industry growth. Although not legally binding, the Guidelines serve as regulatory standards for private equity funds registered in Taiwan.

Taiwan Private Equity Association established in 2023

In June 2022, private equity fund operators applied to the Ministry of Economic Affairs to add "Private Equity Industry" as a group sector and business scope in order to organise a business trade association. In January 2023, the Taiwan Private Equity Association was officially established, with members comprising private equity firms, securities firms, investment trusts, and venture capitals. Since then, the Taiwan Private Equity Association issued the "Self-Regulatory Guidelines for Private Equity Funds Competing for and Acquiring Insurance Funds", which has been signed by a number of private equity fund practitioners.

In April 2023, the NDC became the competent authority for the Taiwan Private Equity Association, extending its role beyond merely providing consultation and guidance. Through collaborating with relevant ministries to review and publicly disclose private equity funds, the NDC aims to proactively channel institutional investment capital into significant strategic industries in Taiwan, promoting industrial and economic development. Overall, these efforts have resulted in a clearer structure and regulatory framework for private equity funds to operate in Taiwan.

Lifers' investments in infrastructure and strategic industries through private equity

In the past, lifers' funds have been strictly regulated by the Financial Supervisory Commission (FSC). After the FSC relaxed the restrictions on lifers' funds and open to invest private equity funds in domestic public infrastructure and core strategic industries, the insurance industry's investment in private equity funds reached TWD91.8 billion by the end of 2023. As of the end of January 2024, the insurance industry's investment in six core strategic industries (ie, information and digital services, information security, precision health, green power and renewable energy, national defence and strategy, public welfare and national defence) amounted to around TWD1.6783 trillion in total.

Conclusion

The Taiwan market offers a wide range of opportunities fuelled by government policies, technological advancements, renewable energy initiatives, and healthcare innovations. Despite global and regional challenges, the local market still presents a welcoming environment and opportunities for private equity investments. In recent years, there has been a rising interest from global investors looking to invest in Taiwanese businesses, as well as an increasingly positive attitude from local private equity funds and industry players.

The establishment of the Taiwan Private Equity Association is a significant milestone for local private equity funds, which not only serves as a platform for interactions between industry players, but also as a bridge for interactions with government agencies. With new regulations permitting private equity funds to expand their fundraising sources, coupled with existing measures such as allowing the insurance industry to invest in these private equity funds, increase in funding for developing key industries and greater opportunities are expected.

UK

Law and Practice

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White & Case LLP is a global law firm with longstanding offices in the markets that matter today. Its premier London-based private equity team serves as the central hub for its EMEA private equity practice, regularly handling complex cross-border transactions. The firm's clients benefit from the bench strength of its extensive EMEA-wide network, which includes specialist private equity teams in key financial hubs across the region. This allows it to meet the diverse needs of its clients, no matter where they conduct business. The firm's London-based partners are deeply engaged across Europe, the Middle East, Africa, and also have a strong presence in the US and APAC regions. This global reach ensures that the firm's clients receive seamless support and expert advice, wherever their investment strategies take them. The London team services the full spectrum of financial sponsors, from traditional private equity firms to alternative capital providers, technology investors, sovereign wealth funds, real estate, family offices, and infrastructure and energy funds. With a deep understanding of the market and a commitment to excellence, the London team is equipped to handle the most sophisticated transactions and provide tailored solutions that drive success.

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1. Transaction Activity

1.1 Private Equity Transactions and M&A Deals in General

2024 has seen a similar number of private equity transactions in the UK compared to 2023. Many of these transactions have been add-on transactions for funds' existing portfolio companies, rather than new platform investments or exits.

There continues to be a lot of activity in the UK takeover market, with purchasers taking advantage of structural discounts for listed UK shares when compared with similar equities in other jurisdictions, plus a weaker (albeit recovering) pound sterling against the US dollar.

1.2 Market Activity and Impact of Macro-Economic Factors

The private equity landscape as a whole in the UK has been affected by continued high interest rates in 2024. Although monetary policy is easing in the second half of 2024, sponsors are still feeling the need to equity underwrite the majority (if not all) of their acquisitions, with attractive debt terms seemingly unavailable for the foreseeable future. There is also a lingering difficulty for sellers and buyers to find agreement on price, with a broad bid-ask spread contributing to a continuing slowdown in larger transactions.

2024 has seen stronger activity from private equity sponsors in the financial services and wealth management industries in the UK, both in terms of new platform and consolidation transactions, notwithstanding inflationary pressures on wages in the sector.

2. Private Equity Developments

2.1 Impact of Legal Developments on Funds and Transactions

Compliance

The Economic Crime and Corporate Transparency Act 2023 introduces a new "failure to prevent fraud" offence, akin to the "failure to prevent bribery" and "failure to prevent facilitation of tax evasion" offences. This new offence is expected to come into effect by April 2025. The new offence will hold large organisations criminally liable if an associate (such as an employee, agent, or subsidiary) commits fraud for the benefit of the organisation or any person to whom services are provided on behalf of the organisation. Moreover, this offence has a wide jurisdictional reach, applying to both UK and non-UK companies where there is fraud with a UK connection (eg, the fraud is committed under UK law or targets UK victims).

Private equity firms and portfolio companies will be able to avoid enforcement action if they have reasonable procedures in place to prevent fraud (or it was not reasonable in all the circumstances to expect the body to have any prevention procedures in place). Government guidance on reasonable procedures is expected in late 2024 and it is anticipated that it will follow the same principles-based approach taken regarding the guidance in relation to the failure to prevent bribery and facilitation of tax evasion offences. Private equity firms and portfolio companies will require an uplift to existing compliance policies and procedures. Private equity houses will also want to check fraud prevention procedures from a due diligence perspective, as they will wish to check if such policies and procedures are in place at a target, and also regarding a potential compliance uplift at portfolio company level post-acquisition.

Sanctions

The last year has not seen the same level of new Russia-related UK sanctions legislation as 2022-2023. However, an expansion of the goods that are subject to UK (as well as US and EU) trade sanctions, continued uncertainty over the meaning of "ownership and control" in the context of the UK asset freeze, and the increased focus of UK and other sanctions authorities on sanctions circumvention – including the announcement of a new sanctions authority (the Office of Trade Sanctions Implementation) to tackle trade sanctions evasion and strengthen enforcement – mean that sanctions due diligence remains an important part of many private equity transactions and particularly those with a connection to Russia.

ESG

By the end of 2024, the UK Sustainability Disclosure Requirements will be fully in force. Although largely influenced by the EU's Sustainable Finance Disclosure Regulation, there are some differences in the disclosure and reporting requirements, while the EU's regulation does not yet include a general anti-greenwashing rule requiring sustainability claims to be "fair, clear and not misleading". Sponsors that are marketing funds to EU and UK investors will therefore need to be careful to ensure that the relevant rules are being complied with.

3. Regulatory Framework

3.1 Primary Regulators and Regulatory Issues

Merger Control

The Competition and Markets Authority (CMA) is the UK's competition regulator, responsible for investigating M&A transactions that may impact competition, enforcing competition laws – such as those against cartels and market dominance abuse – and conducting market studies and investigation to address potential competition and consumer concerns. The UK operates a voluntary merger control system. This means that there is no legal obligation to notify the CMA or seek its approval before implementing a transaction. However, if the transaction meets the relevant thresholds and the parties do not notify, the CMA may launch its own investigation and has extensive powers to impose stringent interim hold-separate orders as well as a range of final remedies, including ultimately to unwind the transaction. Therefore, where material substantive competition concerns arise on an acquisition meeting the relevant jurisdictional thresholds, most private equity buyers will require CMA approval as a condition precedent to closing.

The CMA has the power to investigate and intervene in M&A transactions that meet at least one of the following jurisdictional thresholds: (i) the target's UK turnover exceeds GBP70 million (set to increase to GBP100 million under the new Digital Markets, Competition and Consumers Act (DMCCA); or (ii) the merger results in a 25% or greater share of supply in the UK (or a substantial part of the UK), provided there is an increment in that share. The DMCCA will introduce additional thresholds, granting the CMA jurisdiction if (i) at least one party has an existing 33% share of supply in the UK and a UK turnover of GBP350 million; and (ii) another party has a "UK nexus" (broadly defined to be satisfied where the party has any activity, legal entity or supply of goods or services in the UK). This change removes the current requirement for overlapping UK activities (ie, an increment in the share of supply) and is likely to bring a larger proportion of private equity transactions into scope of the UK merger control rules. Additionally, the DMCCA will introduce a mandatory

notification obligation on companies designated by the CMA as having "strategic market status" if (i) the transaction increases their stake above 15%, 25%, or 50%; (ii) the target company is or will be active in the UK; and (iii) the transaction consideration is at least GBP25 million.

Private equity investors should also note the CMA's increased scrutiny of roll-up acquisitions, with the CMA's CEO Sarah Cardell noting in 2023 that these would "come in for very close scrutiny". This has been evidenced by recent CMA investigations relating to roll-up acquisitions in the dentistry and veterinary industries, which involved acquiring portfolio companies controlled by private equity firms. In many cases, the CMA has reviewed the transaction after completion and only approved the deal subject to remedies (such as divestments) offered by the parties.

Foreign Direct Investment (FDI)

The Investment Security Unit (ISU) oversees and implements foreign direct investment screening in the UK, aiming to protect national security while maintaining the country's appeal to foreign investors. The ISU assesses transactions for national security risks and may block or impose conditions on those deemed too risky. Under the National Security and Investment Act 2021 (NSIA), mandatory filing and ISU approval are required for certain acquisitions if the target's activities fall within one of the 17 sensitive sectors identified by the NSIA, including defence, energy, critical suppliers to government, and data infrastructure. The scope of the NSIA rules goes much further than many other global FDI regimes, which generally require a local subsidiary, assets or at least branch office to be triggered. The UK regime can be triggered by sales to UK customers alone – ie, potential filings under the NSI Act may be required in the context of global private equity transactions even where the target has only a remote UK nexus.

In addition to evaluating the sectors involved, the ISU also considers the identity of the proposed acquirer. For private equity firms, the presence of sovereign wealth funds as a significant LP investor in the acquiring fund may lead to increased scrutiny of an M&A deal, particularly if those investors originate from countries considered to pose a higher national security risk to the UK. Chinese investors have come under greater scrutiny, with 53% of final orders (remedies or prohibition) between 2022 and 2023 relating to transactions involving Chinese entities. Where an acquisition is being made by a consortium of private equity investors careful assessment will need to be made as to whether any of the co-investors poses a greater risk from a national security perspective. In such circumstances, consortium members will need to consider how to appropriately allocate (as between themselves) the risk of mitigations being required to obtain approval (eg, providing for certain investors, if considered individually problematic, to reduce their governance rights, lower their stake or take specific measures to allay potential concerns).

4. Due Diligence

4.1 General Information

Legal due diligence is conducted thoroughly in the UK. Legal due diligence reports are important not only for the private equity sponsor in finding out about any legal risks associated with a target, but also for the purpose of insuring a set of warranties relating to the transaction where the liability for the warranting party/ies is limited to GBP1, or securing third-party financing for a transaction.

Scoping of a due diligence exercise is crucial in ensuring that the key legal (and geographical) areas relevant to a particular target are covered, but in a focused and efficient way. Legal due diligence exercises will almost always cover verification of the ownership of a target and its subsidiaries, details of any third-party shareholdings within the group and details of the contractual arrangements with those parties, key customer and supplier agreements, and employment law issues. The extent to which other areas – such as intellectual property, data protection, or real estate – are focused on will depend on their relevance to a particular transaction. In addition, for regulated businesses, legal due diligence will cover compliance by the target with applicable regimes, and the details of any consents which may be needed from the authorities in connection with the transaction.

Financial, tax, and insurance matters are among those commonly excluded from legal due diligence.

4.2 Vendor Due Diligence

Vendor due diligence is common in structured processes for the sale of UK assets to private equity purchasers, as a good vendor due diligence report can reduce the time needed for purchasers and their advisers to understand the legal issues associated with a target, and to factor them into a transaction. Sell-side law firms will typically provide reliance on their reports to the buy-side, although their contents are commonly more factual in nature, and less likely to give a "view" on legal risk or potential solutions to issues (with some sellers being of the opinion that this is something for the purchaser to form a view on with the aid of its advisers).

5. Structure of Transactions

5.1 Structure of the Acquisition

Sale and purchase agreements govern the transfer of shares and assets in UK transactions where there is no public element to the transaction. For UK take privates by private equity sponsors, the majority of transactions are implemented by a court-approved scheme of arrangement.

5.2 Structure of the Buyer

Private equity sponsors will typically incorporate an "investment stack" of holding companies to, among other reasons, ensure tax structuring efficiency, obtain financing, limit fund-level liability, and set the structure up for an eventual exit. The final entity in the stack will be the "BidCo", the SPV incorporated for the sole purpose of acquiring the relevant shares or assets. The funds themselves will only be party to an equity commitment letter.

5.3 Funding Structure of Private Equity Transactions

Private equity transactions have typically been funded with a mix of third-party debt and equity from the fund and any co-investors. At the time of signing a transaction, an acquiring fund provides an equity commitment letter to its BidCo (enforceable by or also directly addressed to the seller) in which it commits to fund the BidCo with equity up to a capped amount on or before completion. Also at signing, the buyer will deliver evidence of its acquisition finance package (if any) to the seller. This may constitute debt commitment letters appending a financing term sheet (or something in longer form), but crucially will be provided on a "certain funds" basis. This means that any conditions to the provision of financing will be satisfied at signing, and there will be only very limited opportunities for a lender to refuse to fund on completion. Given the continuing dif-

ficulty of obtaining attractive debt terms in 2024, it is becoming more common for funds to fully equity underwrite a transaction, and then try and arrange a financing package before or shortly after completion.

5.4 Multiple Investors

Transactions involving a consortium of private equity sponsors are common in the UK. They permit sponsors to de-risk an investment by reducing their equity funding requirement. More common is a structure where limited partners in the fund making the acquisition are given the opportunity to invest alongside the sponsor. Typically, this is a passive investment by limited partners in a pooled vehicle which invests alongside the sponsor, but in some cases (particularly where an LP is providing a material portion of the overall equity commitment) a limited partner will invest directly alongside the sponsor. This is becoming increasingly common for sovereign wealth funds. It is uncommon in the UK for a private equity sponsor to invest in an asset alongside a corporate or strategic investor, given that these investors will likely have a differing view of the horizon for the timing of an exit (if they consider that an outcome at all).

6. Terms of Acquisition Documentation

6.1 Types of Consideration Mechanisms

Private equity transactions in the UK will typically include either a locked-box or completion accounts consideration mechanism, depending on the nature of the transaction and the competitiveness of the process. Although corporate purchasers (particularly from the US) may be reluctant to use a locked-box mechanism even in the most straightforward acquisition, their identity alone would not typically be sufficient to flip the transaction to completion accounts, particularly in a competitive process. Given the present difficulty in finding alignment between buyers and sellers on pricing expectations, EBITDA or milestone-linked earn-outs are commonly being used to provide greater comfort to purchasers, who may wish to see the results of predicted future growth before paying for it.

6.2 Locked-Box Consideration Structures

A fixed daily ticker is commonly added to the locked-box equity price from the date of the locked-box accounts until completion, to reflect cash profits generated by the target during this period, the benefit of which the buyer would otherwise take (but which would in theory be calculated as part of the target's cash at completion in a completion accounts mechanism). Sometimes, interest is also charged on leakage of value from the locked box to (or for the benefit of) the sellers from the locked-box date to completion, but more usually this is just deducted from the completion purchase price (if identified before completion), or repaid, on a pound-for-pound basis.

6.3 Dispute Resolution for Consideration Structures

A sale and purchase agreement with a locked-box consideration mechanism will not include a specific dispute resolution mechanism regarding the purchase price. The buyer and seller agree the locked-box accounts before signing the transaction, and the buyer should be comfortable that it can recover any leakage from the locked box under the seller's leakage covenant (demonstrating the importance of ensuring that definitions of "Leakage" and "Permitted Leakage" in the acquisition documents are carefully reviewed and negotiated).

On the other hand, completion accounts will be drawn up post-completion, based on a hierarchy of accounting policies set out in the sale and purchase agreement underpinned by definitions of "Cash", "Debt", and "Working Capital", to land at final number, following payment of an estimated consideration amount at completion. Following receipt of the draft completion accounts, the recipient (it could be either the seller or the buyer) will have the opportunity to point out any items of disagreement, along with its supporting argument. If this cannot be agreed between the parties, the sale and purchase agreement will contain a mechanism for resolution of the dispute by an independent expert accountant.

6.4 Conditionality in Acquisition Documentation

Mandatory (but given the context of the antitrust regime in the UK provided above, also including voluntary CMA referrals) and suspensory conditions are typically the only acceptable conditions to completion of the sale of any asset owned by a private equity sponsor in the UK. Material adverse change clauses, or third-party consent conditions, are not prevalent in UK private equity transactions.

6.5 "Hell or High Water" Undertakings

Private equity buyers will often accept "hell or high water" undertakings (requiring the buyer to do everything it can to secure satisfaction of the condition, including agreeing to remedies required by the relevant authorities) in relation to antitrust conditions, but only after doing a significant amount of preliminary work to establish the likelihood of any substantive issues regarding overlapping assets within their portfolios, and where they have a good understanding of the antitrust authority. Any such remedial action will typically be limited to the sponsor's fund making the acquisition, and not its wider universe of funds (which it may not have authority to bind).

For foreign direct investment approval conditions, buyers are much less likely to accept a "hell or high water" obligation, owing not only to the increasing interventionism of FDI regulators but also to the uncertainty surrounding what behaviourial remedies may be required before consent to the transaction is provided. Although not as new (and uncertain) as the EU's FSR regime, intervention under the NSIA is still nascent, and buyers are cautious of agreeing to comply with any, unknown, remedies to get the transaction approved.

6.6 Break Fees

Break fees in favour of the seller, although common in the USA, are not a customary feature of UK private equity transactions.

6.7 Termination Rights in Acquisition Documentation

Conditional sale and purchase agreements in the UK contain a "long-stop date" by which the conditions must be met, failing which the seller typically has the ability to terminate the agreement. After a further period of time (usually between one and three months following the long-stop date) the buyer is usually also permitted to terminate the agreement (provided it is not at fault in failing to satisfy the condition).

6.8 Allocation of Risk

It is generally understood in UK transactions where the seller is a private equity fund that, given the nature of those funds, and their need to return capital to investors, they require a "clean break" as far as possible. For that reason, extending liability beyond the customary limitations is generally not negotiable.

6.9 Warranty and Indemnity Protection

Regardless of the identity of the purchaser, private equity sellers in the UK will typically provide only title and capacity warranties concerning their ownership of the shares and ability to enter into the sale and purchase agreement. Given the fundamental nature of the warranties, liability for breach warranties will typically be capped in time at six years, and in value at the amount of consideration received by the seller, without any de minimis or thresholds. Beyond the leakage covenant described above, private equity sellers will seek to resist providing any other contractual protection to the buyer. On occasion, however, a risk may be so apparent regarding the target's business that the seller will covenant to indemnify the buyer in respect of any loss arising out of that issue. Commonly, these issues are tax related. Any such covenants may be subject to bespoke financial limitations, but will typically be available to a buyer for six or seven years from completion (where tax related).

In addition to title and capacity warranties, a core group of managers will usually be expected to provide a set of business warranties concerning the affairs of the target. Liability for management is typically capped at GBP1, with recourse for the buyer being limited to the W&I policy. Liability under management warranties is typically limited in time to two years, and is subject to exclusions for matters which are disclosed against the warranty, which will usually include a set of specific disclosures in a disclosure letter, but also the contents of a data room prepared in connection with a transaction. The buyer will also not be able to claim in respect of any matters of which it was aware at the time of signing.

6.10 Other Protections in Acquisition Documentation

W&I insurance is a common feature of private equity transactions in the UK. It is most commonly used to insure against breaches of warranties given by the seller or, on a secondary buyout, management, whose liability in respect of the warranties is capped at GBP1.

Given their need to distribute returns back to investors as quickly as possible to preserve IRR metrics, private equity sellers will almost always seek to avoid any sales proceeds being held in escrow. They will always try and push the risk on to an insurer, or otherwise require the buyer to take comfort that the reputational damage to a private equity firm from it not standing behind its liability would be such that in practice, it should never be allowed to happen. This is a position which has survived the recent slowdown in exit transactions in the UK.

6.11 Commonly Litigated Provisions

Litigation under sale and purchase agreements in the UK typically relates to leakage claims (ie, whether or not something was leakage) under locked-box pricing mechanisms, warranty claims (the litigation often focusing on the limitations of the seller's liability in relation to those claims), and earn-out calculations.

Completion accounts mechanisms, although commonly contentious, are arguably less commonly litigated given that the dispute mechanism which they contain usually results in a binding decision of an independent expert absent manifest error, a term which is interpreted narrowly by the English courts.

7. Takeovers

7.1 Public-to-Private

Public-to-privates involving private equity-backed bidders are very common in the UK. The roles of the target company and its board are broadly the same as in other public company takeover transactions, but there are unique features particularly where members of the management team are to have a continuing role in the business.

The Takeover Code requires the target board to obtain independent advice as to whether the financial terms of any offer are fair and reasonable and must ensure that the substance of the advice is made known to its shareholders. This is particularly important in a management buyout (MBO) or similar transaction where the independence of the adviser must be beyond question.

The Takeover Code also contains special provisions regarding information that must be provided to the target's independent directors and a competing bidder in an MBO or similar transaction. In such transactions, the bidder must provide to the target's independent directors all information which it has provided to external providers of finance. In addition, information generated by the target (including its management acting in that capacity) which is passed to external providers or potential providers of finance to the bidder must be provided to a competing bidder.

Special rules also apply to management incentivisation arrangements that the bidder intends to provide. These need to be disclosed in the offer documentation and the target's financial adviser will need to state in the documentation that the arrangements are "fair and reasonable".

Where shares are being provided to management on a basis which is not being extended to other shareholders, the arrangements will need to be approved by the target's shareholders.

As with any other public company takeover, it is common for the target and bidder to enter into a co-operation agreement, particularly where the transaction is structured as a scheme of arrangement. These agreements cannot contain offer-related arrangements that are prohibited under the Takeover Code, such as exclusivity undertakings, undertakings relating to the conduct of the target's business and warranties relating to the target business.

7.2 Material Shareholding Thresholds and Disclosure in Tender Offers

Under the Listing Rules, a shareholder is required to notify a listed company (which in turn must issue an announcement) when certain thresholds are crossed. For UK issuers, the threshold is 3% and each 1% threshold thereafter. For non-UK issuers, the threshold is 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75%.

The Takeover Code also requires the bidder, target and certain other parties to make an opening position disclosure relating to interests held in the bidder's or target's securities at the start of an offer period or, if later, after the announcement identifying a bidder. The parties are also required to make dealing disclosures of any subsequent deals in such securities.

Where an offer is structured as a contractual offer (as opposed to a scheme), the bidder is also required to announce the level of acceptances reached at various stages during the course of the offer.

7.3 Mandatory Offer Thresholds

The Takeover Code requires an offer to be made when a person acquires an interest in shares in a Takeover Code company which, when aggregated with any shares held by that person and by persons acting in concert with it, carry 30% or more of the voting rights of a company. A mandatory offer is also required if a person, or any person acting in concert with it, increases its share interests, where the person and its concert parties held between 30-50% of the company's voting rights before the acquisition.

The Takeover Code presumes that certain categories of persons will be presumed to be acting in concert with each other unless the contrary is shown. These include portfolio companies with a private equity bidder where the bidder has a controlling interest in the portfolio companies and limited partners in a private equity fund where the limited partner's interest in the fund is 30% or more. The Panel may agree that the presumption of acting in concert will only apply from the earlier of when the bidder is first identified and the portfolio company or limited partner is made aware of a possible offer.

7.4 Consideration

The majority of public-to-privates involving private equity houses are cash only bids, but there has been an increased use of stub equity in recent years. The driver for this is sometimes a key target shareholder wishing to retain an ongoing economic exposure in the target, which necessitates extending this to other shareholders under the Takeover Code rules that require target shareholders to be treated equally.

Acquisitions of target shares during the offer period and in the three months before the start of the offer period will normally result in the offer price having to be at least equal to the highest price paid for the shares. Acquisitions of target shares during the offer period and in the twelve months before the start of the offer period (for cash acquisitions) or the three months before the start of the offer period (for acquisitions made in exchange for securities) may also result in a requirement to offer a particular form of consideration as well as setting a minimum offer price, depending on the percentage of target shares acquired and whether the dealing took place before or during the offer period.

7.5 Conditions in Takeovers

Takeover offers are usually subject to a wide range of conditions, including an acceptance condition (for contractual offers), conditions relating to the scheme process (for schemes), anti-trust and other regulatory conditions, conditions relating to the target's business, shareholder approval and listing conditions. However, the ability of the bidder to invoke a condition is restricted by the Code. Any conditions should not be subjective in nature or be ones where the fulfilment is in the bidder's hands.

Where the offer is for cash, or includes an element of cash, and the bidder proposes to finance the cash consideration by an issue of new securities, the offer must be made subject to any condition required, as a matter of law or regulatory requirement, in order validly to issue such securities or to have them listed or admitted to trading. Subject to this, a bidder is not permitted to make its offer conditional on financing. In addition, where the offer includes cash consideration, the bidder's financial adviser is required to confirm in the offer documentation that the bidder has sufficient resources to satisfy full acceptance of the offer. The effect of this is that any finance documentation can only be subject to very limited conditions.

The Takeover Code prohibits a target company from agreeing a break fee except where it has announced a formal sale process or where another bidder has announced an unrecommended offer and the target company wishes to agree a break fee with a competing bidder. Where these exceptions apply, any break fee must be de minimis (usually no more than 1% of the offer price). The Takeover Code also prohibits other deal protection measures ("offer-related arrangements") such as matching rights, force-the-vote provisions, non-solicitation provisions and requirements to notify the original bidder about any approach received. A target company can, however, enter into non-disclosure agreements, agreements not to solicit employees, customers and suppliers, and agreements that only impose obligations on the bidder.

7.6 Acquiring Less Than 100%

Where a takeover is structured as a contractual offer, the bidder will usually make its offer conditional upon it acquiring not less than 90% of the shares to which the offer relates. This is because this is the threshold at which a bidder can exercise squeeze-out rights to buy out minority shareholders. A bidder will often waive a 90% acceptance condition when acceptances have been received in respect of 75% of shares carrying voting rights, since at this level the bidder will be able to pass special resolutions and apply to have the target delisted. Where the financing arrangements require the target group to give financial assistance (for example by charging their assets), the target company will need to re-register as a private company, which will require a special resolution. Where debt finance is used to fund the bid, the lender's permission will usually be required for the bidder to waive down the acceptance condition to below 90%.

However, most UK takeovers are implemented as a scheme of arrangement and, under this structure, the bidder will acquire 100% of the target company's shares upon the scheme becoming effective.

7.7 Irrevocable Commitments

Given the Takeover Code restrictions on break fees and other offer-related arrangements, a bidder will often seek irrevocable commitments from the target board and from key shareholders. These are usually procured before a firm offer is announced, although the requirement to keep the potential offer secret and the so-called rule of six will limit the number of shareholders that can be approached before a possible offer or firm offer is announced. Where the takeover is structured as a contractual offer, the UK Market Abuse Regulation prohibition on persons discharging managerial responsibilities dealing in shares will restrict the directors' ability to enter into irrevocable commitments during a closed period.

Irrevocable commitments provided by the target board will usually continue to be binding even if a higher competing offer is announced ("hard"), but commitments provided by institutional investors will often cease to be binding if a higher competing offer is made ("soft") or if a competing offer is made a certain percentage above the original bidder's offer price ("semi-hard"). Where the commitment is soft or semi-hard, it is common for the bidder to reserve the right to improve its offer so that it is at least as favourable ("matching right") or exceeds ("topping right") the value of the competing offer, in which case the irrevocable commitment will not lapse.

8. Management Incentives

8.1 Equity Incentivisation and Ownership

Private equity sponsors need to ensure that their interests are aligned with those of their portfolio companies' management teams. Accordingly, management is usually granted ownership of a portion of the business – in the UK, it is typical for management to hold between 10 and 20% of the ordinary shares of the company, via a so-called sweet equity pot.

8.2 Management Participation

Management sweet equity takes the form of ordinary shares. Typically, subject to investor tax advice, the value of these shares is structured such that the fair market value is as low as possible at the point of acquisition, giving management the greatest possible chance of upside in a successful exit scenario. A minority of management incentive schemes in the UK also include a performance-based ratchet element, further incentivising management by entitling them to a greater share of exit proceeds in the event that the private equity investor reaches certain returns thresholds. Some more senior managers may be encouraged to invest alongside the private equity investor in the institutional strip, a mix of fixed-return instruments and ordinary shares typically in the ratio of 99:1 or 98:2.

8.3 Vesting/Leaver Provisions

When managers leave the business, their shares are typically subject to a call option in favour of the private equity sponsor controlling the company (or the company itself). Vesting is relevant for those management incentive plan participants who leave the business before an exit is completed by a private equity sponsor. In particular, it is important for those managers who leave but are neither "Good Leavers" (eg, people who die or retire at mandatory retirement age and who receive fair market value for all of their sweet equity), "Bad Leavers" (eg, where managers are terminated for cause (or, in some cases, resign), and receive the lower of cost and fair market value for all of their shares), nor "Very Bad Leavers" (a more punitive category dealing with "bad acts" of managers, and who may receive a discount to cost or (if lower) market value). This category of "Intermediate Leaver", namely managers who are terminated other than for cause, or who resign, will receive fair market value for those of their incentive shares which have vested, and the lower of cost and fair market value for the remainder.

In the UK, vesting typically occurs on a "cliff" vesting on an annual basis over four or five years, although the final 20 or 25% of incentive shares typically only ever vests on exit. On an exit, 100% of incentive shares will vest. Shareholder agreements with management contain detailed provisions around the determination of fair market value, the timing of payment for leaver shares, and what happens to the incentive shares repurchased from managers (usually, these are held for the benefit of future managers who will also need to be incentivised).

8.4 Restrictions on Manager Shareholders

Restrictive covenants are a key tool for private equity sponsors in protecting their portfolio companies from managers who leave and who may seek to divert business away. Market practice in the UK is that carefully drafted non-compete undertakings will have a duration of 18-24 months from cessation of employment for senior managers, and around 12 months for more junior managers. As has also recently happened in the US, non-compete undertakings are firmly in the crosshairs of the CMA, whose CEO has said the rules "may need updating" given the prevalence

of non-competes in employment agreements in the UK. This accords with the stated objective of the previous UK government to limit the maximum term of a non-solicit to three months – although only in employment contracts. It is typical for private equity sponsors to ensure that restrictive covenants are also included in the shareholders' agreement, which the courts in England have typically been more likely to enforce on the grounds that they are more likely to have been negotiated and the power imbalance is less pronounced.

For non-solicitation undertakings, a period of 18-24 months is customary, beginning either on termination of employment or (less commonly) the date of repurchase of securities. Covenant durations being reduced by garden leave is increasingly common in the UK market, though by no means universal.

Customary confidentiality and non-disparagement clauses will also be included in shareholders' agreements.

8.5 Minority Protection for Manager Shareholders

Managers will not typically have a suite of operational vetoes which limit what the private equity sponsor, as the controlling shareholder, can do with the business, or in what circumstances an eventual exit may take place (an exception to this might be made for a founder or senior manager who holds a material portion of the institutional strip and may wish to be treated more like a co-investor for these purposes).

Management protections are limited to fundamental protections of their economic position. Managers will usually be entitled to pre-emptively subscribe for new securities alongside the sponsor, but only if they subscribe for the same proportion of securities as the sponsor subscribes for. Managers, who may not have the liquidity to follow their money and subscribe for additional institutional strip, will often seek additional protection around the price at which further securities in the company are issued (referring to an independent fair market valuation, or the most recent fund valuation conducted by the sponsor). However, private equity sponsors will push back hard on this as they seek to maintain the flexibility to inject further capital on terms which they deem fit.

9. Portfolio Company Oversight

9.1 Shareholder Control and Information Rights

Controlling private equity sponsors will control the boards of their portfolio companies (including, if needed, any subsidiaries of the Topco where the investor directors usually sit). To preserve the value of their portfolio companies, they will also insist on a detailed list of consent matters – operational actions which the managers of the business (who run it day-to-day) cannot take without the consent of the sponsor. Controlling sponsors will also have access to as much information as they require from the portfolio company, in addition to the usual management accounts and other financial information.

9.2 Shareholder Liability

A core tenet of private equity investing is the importance of preventing the liabilities of a portfolio company from affecting the fund itself. English company law generally supports this position – case law has confirmed that in all but the most extraordinary circumstances (for example, where a company is interposed to evade the liabilities of a shareholder) a limited company's liability does not extend to its own-

ers. The Supreme Court has, however, recognised that in some cases, a parent company (having greater scope to intervene in the affairs of its subsidiary) may assume a duty of care in relation to the activities of a subsidiary where it establishes "group-wide" policies or standards regarding certain matters and takes responsibility for compliance with them (or holds itself out as having implemented such policies, even if it does not in fact do so). Although the case in question concerned a multinational mining company, private equity sponsors will need to give due thought to the control they are assuming over portfolio companies, and any statements they make about ensuring their portfolio companies do things in an "environmentally friendly" way, for example.

Sponsors also need to be conscious of the circumstances in which a shareholder may be deemed by UK regulatory authorities to assume responsibility for matters affecting its subsidiaries. The CMA has already issued fines directly to private equity funds for the anti-competitive practices of their portfolio companies, and guidance issued by the UK's Information Commissioner's Office also confirms that it may hold parent companies (which could include private equity funds) jointly and severally liable for the data protection law breaches of their subsidiaries.

10. Exits

10.1 Types of Exit

Sales by private equity sponsors of portfolio companies to other financial investors or strategic players have been the most common form of exit in the UK in 2024. The UK IPO market – while showing signs of recovery and with a simplification of FCA Listing Rules on the horizon – has not been a common private equity exit strategy for some time. There have only been seven IPOs of portfolio companies in the UK since 2022, according to Prequin.

As an alternative to an "exit", in the current climate, many sponsors are choosing to hold on to portfolio companies by transferring them to new funds or continuation vehicles, sometimes combining this by bringing in new co-investors to provide additional capital.

10.2 Drag and Tag Rights

A controlling private equity shareholder will typically have the right to drag all other shareholders pro-rata in a transaction where it sells a majority of the shares in the target to a third party. Management will usually be dragged 100% in such a transaction. Tag-along rights, where the selling sponsor elects not to drag, will also be available to the minority shareholders, typically on terms mirroring the drag.

Where sponsors sell an asset to another of their funds, they will also seek to include an obligation for managers to roll a portion of their sale proceeds into the new structure, to prevent them cashing out completely. However, most sponsors in the UK market accept that a transfer between funds will constitute an exit and management's tag right will apply if the original investing fund loses control. Often this is drafted to provide that exit provisions for management are only not triggered if the transfer between funds does not trigger carry rights in the original fund.

10.3 IPO

Private equity sellers will typically agree to a lock-up period (during which it cannot dispose of its shares in the listing vehicle) of 180 days for a premium listing. Senior management will be subject to a longer lock-up period of one year.

The revised Listing Rules have removed the need for a private equity sponsor with a stake of 30% or more post-IPO to enter into a relationship agreement with the company, but the listed company must still be independent from the controlling shareholder. More flexible capital structures are also encouraged under the new Listing Rules, including the ability for the listed company to have a dual-class share structure where pre-IPO shareholders (including the private equity sponsor, subject to a ten-year sunset clause) can enjoy greater influence post-IPO, subject to compliance with the requirement for independence from the controlling shareholder.

*Ben Tansey (associate) contributed to this chapter.

Trends and Developments

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White & Case LLP is a global law firm with longstanding offices in the markets that matter today. Its premier London-based private equity team serves as the central hub for its EMEA private equity practice, regularly handling complex cross-border transactions. The firm's clients benefit from the bench strength of its extensive EMEA-wide network, which includes specialist private equity teams in key financial hubs across the region. This allows it to meet the diverse needs of its clients, no matter where they conduct business. The firm's London-based partners are deeply engaged across Europe, the Middle East, Africa, and also have a strong presence in the US and APAC regions. This global reach ensures that the firm's clients receive seamless support and expert advice, wherever their investment strategies take them. The London team services the full spectrum of financial sponsors, from traditional private equity firms to alternative capital providers, technology investors, sovereign wealth funds, real estate, family offices, and infrastructure and energy funds. With a deep understanding of the market and a commitment to excellence, the London team is equipped to handle the most sophisticated transactions and provide tailored solutions that drive success.

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2024: A Year of Recovery?

2023 was, for many private equity dealmakers, the most difficult year in recent memory. Geopolitical crises continued to dominate global headlines, fostering a sense of uncertainty, which contributed to a 60% fall in global private equity investments according to publicly available data. But it was a broader macroeconomic malaise which had the greatest impact in the UK: the Bank of England continued raising interest rates until August 2023, whilst grappling with stubbornly high inflation throughout the year.

Against the sombre backdrop of 2023, the outlook for 2024 was cautiously optimistic. An easing of UK monetary policy was anticipated, which, combined with a hope that buyers and sellers would reach an equilibrium on pricing expectations, was expected to lead to a more buoyant market. On first glance, the data seems to tentatively support this view: public data shows that UK private equity transactions in the first seven months of 2024 followed global trends, with transaction volumes ticking upwards slightly compared to the same period in 2023, albeit with aggregate deal value trending downwards. Furthermore, a majority of private equity transactions in 2024 have been identified as being add-ons by existing portfolio companies (increasing slightly compared to 2023), suggesting funds remain more focused on strategically positioning their existing portfolios, rather than executing new platform deals or exits to the extent seen in the first few years of the 2020s.

Fundraising is showing signs of recovery compared to 2023. According to Private Equity International, private equity funds closed USD408.6 billion of commitments globally in H1 2024, compared to USD374.6 billion in the same period last year, although tellingly, funds closed in H1 2024 were marketed for an average of 18 months before final close (up from 15 months in 2023 and 12 months in 2022), suggesting that limited partners struggle to commit to new funds at a time where a subdued exit market is stifling distributions back to them. At the same time, the number of funds closed has been trending downwards each year since reaching a peak in 2021, suggesting that capital is becoming concentrated into the hands of a smaller pool of sponsors. 2024 has already seen several consolidation transactions in the UK private equity and infrastructure asset management industries.

Bridging the Capital Gap

The era of low interest rates and inexpensive access to credit markets in the UK appears to be over for the foreseeable future. This has added some stress to the leveraged buyout model: unattractive debt terms have meant that private equity sponsors are having to write bigger equity cheques to be able to finance transactions. According to data from Pitchbook, 2023 was the first year since records began where leveraged deals were financed with more equity than debt, and this is a trend that is expected to continue.

S&P Global Market Intelligence states that private equity sponsors have available to them more undeployed capital than ever before at the end of H1 2024, meaning that, for now at least, there is sufficient capacity to accommodate outsized equity commitments. In fact, it has been common for sponsors in 2024 to entirely equity underwrite UK buyouts, and then seek to put in place third-party financing at a later date. However, as the fundraising environment becomes ever more competitive and timelines are drawn out, some sponsors may not always be able to rely on the ability to underwrite their own deals and will need to be more creative in their approach to funding transactions, particu-

larly large cap transactions where debt has historically played an even more prominent role.

Sponsors have increasingly looked to their limited partners during 2024 to co-invest alongside them in transactions, reducing the amount of capital that the sponsor needs to deploy itself. In fact, providing access to direct co-investment opportunities has been a key selling point for general partners in their fundraising efforts. This year many limited partners, in particular sovereign wealth funds, are seeking to take advantage of both the governance rights and the lower fees that come with a direct co-investment.

Pricing

An impediment to a return to a higher volume of private equity transactions in the UK appears to be a degree of continuing reluctance on the part of sellers to accept lower multiples in a period of higher interest rates. Attempts to bring together buyers and sellers on pricing have resulted in an increase in earn-out mechanics, as buyers are often unwilling to pay a premium for anticipated future revenue growth and instead will only pay for growth that has actually been delivered. Some sellers are also being asked to re-invest into the target company as part of a transaction. Not only does this enable purchasers to reduce the amount of capital that they need to draw from limited partners to fund an acquisition, but it also tests the seller's faith in the valuation and the potential for future growth.

Elsewhere in the UK, anticipated pricing challenges have led some private equity sponsors to extend hold periods and delay the initiation of exit processes for all but the crown jewels of their portfolios (where processes have remained extremely competitive and prices resilient, with bidding wars maintaining higher multiples for sellers), notwithstanding the ever-present need to generate liquidity for limited partners, as described below. There has also been an increasing trend for sponsors and their advisers to source bilateral deals, where without the competitive tension of an auction process, a buyer has more time to spend performing due diligence on a target to get comfortable with a valuation.

Instead, private equity sponsors are increasingly choosing to focus on ensuring that their UK portfolio companies are in the best possible shape, primed for an exit when conditions are more favourable. For portfolio company general counsel and their legal advisers, there has been a push to identify, and address, potential legal value items ahead of the launch of an exit process. For those portfolio companies which are performing satisfactorily, this has entailed a renewed focus on improving operational performance, growing revenue and margins organically. From a legal perspective, key tasks include the renegotiation of contracts with customers and suppliers, both from a pricing mechanic perspective and in improving terms, minimum volume obligations, and liability provisions – protecting and enhancing the quality of revenues wherever possible. Compliance also remains a key focus, with an emphasis on updates to anti-bribery and corruption and data protection policies and procedures.

As described above, there has also been an increased tendency to make strategic add-on acquisitions to portfolio companies, in an attempt to inorganically dial-up exit multiples by "completing the puzzle" – strategically expanding into markets beyond the UK, or focusing on horizontal integration, and adding value by working on post-acquisition integration into the portfolio company.

Where performance is lagging within the portfolio, private equity sponsors have taken the opportunity to implement turnaround or other restructuring plans, sometimes requiring the injection of additional equity (at lower valuations, with the hope of realising greater gains in the future). If existing management incentive equity is underwater (the value of the business being less than the third-party acquisition debt and the shareholder debt coming from the sponsor, and so is insufficient for incentive equity to participate in exit proceeds), sponsors will often reset the plan to make sure that management's interests are more closely aligned with their own in ensuring maximum value on exit. In the UK, this often results in the creation of a new class of growth shares, or an amendment of the rights attaching to existing shares or shareholder debt (typically the coupon or hurdle rate), but can also take the form of a contingent cash exit bonus, particularly where an exit process is already underway.

Meeting a Need for Liquidity

As noted above, 2024 has not seen a resurgence in UK exits by way of secondary buyouts. The IPO market in the UK is also not attracting listings in the same way that other European financial centres seem to be achieving – there were only eight new additions to the London Stock Exchange in H1 2024. Many are hoping that the change in government following the election in July will deliver clarity in capital markets policy in the UK and, combined with an overhaul and simplification of listing rules by the FCA, we may see the UK IPO market back open for business in the not-too-distant future. But since private equity sponsors are judged on their ability to generate returns for their limited partners, waiting for market conditions to improve is not a luxury that can be relied on indefinitely, and an increasing number are turning to less conventional methods of generating liquidity in 2024.

The raising of continuation funds, whether single asset or relating to a series of diversified assets, has increased in popularity as a way for private equity sponsors to leverage their knowledge of existing portfolio companies and their management teams and to keep hold of promising assets, despite the life of the holding fund drawing to a close. The transfer between funds provides the chance for liquidity for outgoing limited partners, and the opportunity to unlock new capital for use within the portfolio in the future. Pricing on GP-led secondaries remains structured to address conflicts of interest between sponsors and their limited partners: deferred payment and EBITDA-linked earn-outs have become increasingly common over the last few years, and there is an expectation that the GP will roll a meaningful portion of its capital into the new structure. Continuation fund-level debt financing also remains available as part of these transactions, with leverage providing the possibility of an enhanced returns profile. However, lenders are not typically content to take security over the holding entity and cashflows of a (typically less diversified) continuation fund, as is the case with a typical NAV facility. They will also look upwards and seek security over the uncalled capital of the continuation fund.

An Opportunity in Public Markets

One area in which UK private equity activity has continued to be resilient is in takeovers of listed UK companies (known as "take-private" or "public-to-private (P2P)" transactions). The aggregate deal value of UK public-to-private transactions completed in H1 2024 is up 21% compared to the same time last year, with private equity sponsors taking advantage of favourable exchange rates and structural discounts for

UK equities compared to those listed on other exchanges. Although the number of P2Ps as a percentage of firm offers in H1 2024 is lower than in the same period in 2023, this can partially be explained by an increasing number of corporates (particularly in the USA, where 12 of the 29 firm offers in H1 2024 originated) utilising their strong balance sheet positions to fund acquisitions in a tighter debt market. High-profile UK P2Ps have continued into H2 2024, with direct lenders clubbing together to provide finance for the larger transactions.

Carried Interest

Political change in 2024 in the UK has led to uncertainty around the future tax treatment of carried interest – the profits of a fund distributed to its investment managers – the capital gains treatment of which has been described as “absurd” by the new Chancellor of the Exchequer and, by various other commentators as a “loophole”. However, as many of the responses to the call for evidence published by the government are likely to point out, successive governments of all political leanings have maintained this tax rule as a general principle (notwithstanding changes to the rate of tax on the capital gains or the introduction of income-based carried interest rules which have regard to the average holding periods for fund assets) over a period of decades, allowing the private equity industry, and its portfolio companies, to flourish and turn the UK into (in the government’s words) “a world-leading asset management hub”. To what extent the government’s response to the call for evidence will be to treat all carried interest as income, or to further refine the existing rules (for example, by increasing the required holding period required to qualify for capital gains treatment or requiring material participation by investment managers alongside other investors in their funds), remains to be seen.

*Ben Tansey (associate) contributed to this article.

USA

Trends and Developments

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Debevoise & Plimpton LLP is a trusted partner and legal adviser to a majority of the world's largest private equity firms, and has been a market leader in the private equity industry for over 40 years. The firm's private equity group brings together the diverse skills and capabilities of more than 500 lawyers around the world from a multitude of practice areas, working together to advise clients across the entire private equity life cycle. Clients include Blackstone, The Carlyle Group, Clayton, Dubilier & Rice, HarbourVest, Kelso & Company, KKR, Morgan Stanley, Providence Equity, Temasek and TPG.

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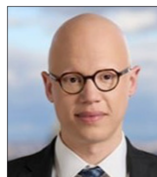

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Overview

In the beginning of 2024, the year ahead was viewed with "guarded optimism." From the vantage point of the third quarter, that perspective has been borne out. Private equity M&A deal activity in the USA has gathered steam, and while the market in Europe is still finding its stride, sponsors investing there are finding opportunity in certain sectors and market niches. The robust secondaries market continues to fill the gap where attractive exit opportunities are not available via the IPO market or third-party sales. Positive momentum on the dealmaking front is in turn giving sponsors hope that the fundraising environment may begin to warm.

But if market conditions are gradually becoming more stable (and favourable), the regulatory and enforcement environment is another matter. ESG-related regulations in the EU and UK are an ever-evolving landscape, while in the USA they provide the stage for increasingly polarised legislative battles. At the end of June, the US Supreme Court issued two decisions with the potential to significantly upend the regulatory and enforcement environment: one holding that courts no longer must defer to an agency's interpretation of regulations, and the other calling into question the SEC's ability to pursue penalties through its in-house administrative proceedings. Both decisions promise to bring uncertainty and unintended consequences.

Fundraising

The fundraising market is beginning to benefit from the improved financial conditions that have slowly brought dealmakers back to the table. Transactional markets – particularly in the USA and Europe – gradually began to thaw over the first half of 2024, and there is a cautious optimism that the uptick in deal activity will persist throughout 2024 and accelerate in 2025. That outlook gives fund sponsors and investors hope of unlocking liquidity and is creating a bit of momentum for new funds across asset classes. While raising capital is still taking longer than it did in 2020 and 2021, and remains challenging amidst macroeconomic uncertainty, the market is warming a bit – particularly for larger fund managers and funds targeting more than USD1 billion.

To that end, the private funds market continues concentrating in brand name mega funds where investors believe there is both opportunity and more certainty. While these funds are not immune to the challenges of this fundraising environment, they have weathered it better than most. That durability improves their outlook for the remainder of the year and beyond.

Conversely, middle market and smaller firms continue to face prolonged capital-raising periods for funds launched over the past two years. A number of these firms have extended fundraising periods, offered or expanded fee reductions, and customised other offers to attract investors. Patience and creativity have been essential given the number of investors facing a liquidity crunch and reducing their private fund allocations or the number of managers they partner with.

The first half of 2024 also saw investors focusing on asset classes and sectors with countercyclical characteristics – or that would be too risky to pass up. Private credit funds continued to attract capital, offering a safe haven and an opportunity to achieve equity-like returns in today's "higher for longer" interest rate environment. Open-end credit funds have been particularly appealing as a source of more predictable liquidity, and many sponsors in the market have been very active in the space. In another vein, AI is the opportunity no firm wants to miss. The technology is already

so pervasive, and the transformational opportunity so evident, that sponsors throughout the private markets are trying to catch AI tailwinds that may boost their portfolios. That has made AI a very bright spot across the dealmaking and fundraising markets, from early-stage venture funds to later-stage growth and private equity funds.

Also continuing is strong interest in secondaries funds – perhaps not surprising, given that traditional exit routes have been so limited – and secondary exits have surged. The secondaries mega funds have been scaling, and managers continue to introduce new fund products, to capture a portion of this growing market.

Some sponsors are waiting for conditions to improve prior to launching new products in hopes of avoiding some of the market's current supply-and-demand imbalance. Others are moving more aggressively into retail capital, which presents an enormous opportunity for sponsors equipped to pursue it. It is expected the trend will persist, and for sponsors to continue seeking new distribution channels that could unlock capital and provide a bulwark against future downturns.

While caution remains the theme of 2024, there are the fledging signs of optimism, opportunity and signs of liquidity in several areas in the market.

Private Funds Transaction

The secondaries market has been seeing an uptick in venture capital (VC), credit and strip sale continuation fund transactions – and the growing popularity of these transactions has prompted existing co-investors to seek additional protections.

Venture capital continuation fund transactions

The venture capital GP-led secondaries market has picked up momentum, as investors seek liquidity amidst a slow market for IPOs and traditional M&A exits. While there were a few noteworthy VC continuation fund transactions in 2022 and 2023, 2024 has been characterised by a significant uptick in activity. This trend is expected to continue, as the last 12 months have seen existing sponsors in the VC secondaries market close funds significantly larger than their predecessor funds and new sponsors enter this part of the secondaries market. As before, pricing remains a challenge, however, as the bid-ask spread for VC assets continues to be one of the widest of all asset classes in the secondaries market. There has also been an increase in VC secondaries funds designing bespoke liquidity solutions for founders, employees and other early investors in VC-backed companies, providing those funds an additional avenue for accessing investment opportunities in target companies. For example, a fund may enter into a financing arrangement with such individuals secured by a pledge of securities in the target company in return for a negotiated minimum return coupled with an incentive payment at the time of an IPO or sale of the target company.

Credit continuation fund transactions

While there has been considerable discussion over the last couple of years regarding the impending rise of the credit GP-led secondaries market, activity during much of that period was overwhelmingly concentrated in traditional portfolio deals and NAV loans. However, the last six months has seen several significant credit continuation fund transactions come to market. Credit secondaries transactions will typically involve a highly diversified portfolio that is principally comprised of numerous debt investments

and a comparatively small number of post-reorganisation equity positions. Legacy limited partner (LP) selling volume is difficult to predict at this stage, but anecdotally, legacy LP interest in liquidity with respect to credit portfolios has been somewhat muted in comparison to single-asset equity continuation fund transactions, where legacy LP selling volume has generally remained in the 80%-90% range for a number of years.

Strip sale continuation fund transactions

Over the last 12 months, there has been a notable uptick in strip sale transactions, that is, transactions in which a sponsor causes the selling fund to sell only a portion of one or more existing portfolio investments to a continuation fund. Typically, in a strip sale transaction, there is no rollover or reinvestment option offered to legacy LPs and the sponsor will seek to align the legacy fund's and continuation fund's exits from the commonly held portfolio investments. Particularly when sponsors are not concerned about an impending end of the legacy fund's term or about a lack of go-forward capital to support portfolio investment growth, strip sale transactions provide one way to boost the legacy fund's Distribution to Paid-In Capital ratio – and do so more quickly than typical continuation fund transactions due to the absence of an LP election process.

Co-investors in continuation funds

The treatment of co-investors in LP election processes for continuation funds remains an issue for negotiation between sponsors and co-investors. Many sponsors have been unwilling, at the outset of a co-investment, to take a position on whether co-investors would be given the option to either exit, to maintain the status quo (ie, remain invested through a fee and carry-free co-invest vehicle) or to subscribe to a continuation fund with different economics. Instead, those sponsors have preferred to retain for themselves the right to decide at the time they undertake the continuation fund transaction whether to "drag" the co-investors along or to offer them an option to cash out. Co-investors, on the other hand, would like more certainty at the outset regarding their options in the event a continuation fund is organised, including the ability to preserve the economics they have under the terms of the original co-investment. Market terms on this point remain in flux.

M&A

The first half of 2024 has brought an uptick in US private equity M&A deal activity. Although the number of completed deals remains below that of 2021 and early 2022, thus far 2024 would have been considered healthy deal activity in prior periods.

Buyers and sellers are closer, in general, to a meeting of the minds on price than they have been in some time, even if interest rates continue to present a challenge to PE buyers in modeling attractive returns at a price that will motivate a seller. Debt financing has been reasonably available, and the expectation that rates will remain where they are for at least the medium term – ie, that there is a "new normal" – has prodded parties into action and off the sidelines waiting for rates to drop.

Given elevated public equity valuations, take-private deal volume had fallen off considerably during the beginning of 2024 (despite certain mega deals, such as Silver Lake's agreement to take Endeavor private), with sponsors instead focusing on carve-out and add-on deals, but there has been a resurgence of interest in take-privates in Q2. At the exit end of the life cycle, sale processes are being initiated more frequent-

ly today than in the prior 18 months (including for some long-in-the-tooth assets), though with mixed results.

There continues to be a substantial number of continuation fund deals, which appear to have established themselves as a permanent part of the PE landscape. The combination of new third-party capital and continued control for the sponsor that these funds offer is particularly appealing in a still somewhat challenged dealmaking environment.

The regulatory environment remains a focus for market participants. While the threat of regulatory action isn't preventing deals from signing, the practical realities of dealmaking in an era of aggressive regulation can be seen in the amount of time and energy spent in negotiating terms such as efforts covenants, closing conditions and reverse termination fees.

Although 2024 has yet to unleash the torrent of activity some have hoped for, the war chests of dry powder held by sponsors, along with a period of relative stability in the debt markets, lead to the expectation that the gradual increase in US private equity M&A activity will continue. There is always the possibility of pre-election skittishness disrupting these generally favourable conditions, but so far there has been no evidence of that bearing out.

SEC Enforcement

The first half of 2024 saw two developments regarding SEC enforcement that have particular importance for the private equity industry: the US Supreme Court's ruling in SEC v Jarkesy regarding the SEC's in-house administrative proceedings, and the settled enforcement action by the SEC against J.P. Morgan Securities for violating SEC whistleblower anti-impediment rules.

SEC v Jarkesy

On 27 June 2024, the U.S. Supreme Court issued its highly anticipated ruling in SEC v Jarkesy, holding in a six-to-three ruling authored by Chief Justice Roberts that the Seventh Amendment right to a jury trial precludes the SEC from pursuing penalties for securities fraud violations through in-house administrative proceedings in which an administrative law judge (ALJ) makes factual findings.

In 2013, the SEC instituted administrative proceedings against George Jarkesy and his investment adviser, Patriot28, in connection with two hedge funds advised by Patriot28, alleging that Jarkesy and Patriot28 violated the antifraud provisions of the federal securities laws through various misrepresentations to investors. After an ALJ found for the SEC, both respondents petitioned the Commission for review (which operates as a de novo appeal of the ALJ's decision). After six years, in 2020, the Commission affirmed the ALJ's finding; the SEC then imposed cease-and-desist orders on Jarkesy and Patriot28, ordered Jarkesy and Patriot28 to pay a USD300,000 penalty and Patriot28 to pay disgorgement of more than USD680,000, and prohibited Jarkesy from further involvement in the securities industry.

Jarkesy and Patriot28 appealed the Commission's agency's decision to the US Court of Appeals for the Fifth Circuit, which ruled in the two respondents' favour, holding, among other things, that in the SEC's administrative proceedings, Jarkesy and Patriot28 were deprived of their constitutional right to a jury trial. The SEC appealed the Fifth Circuit's decision to the US Supreme Court, which granted certiorari.

On 27 June 2024, the Supreme Court affirmed the Fifth Circuit ruling, holding that Jarkesy and

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Patriot28 had been deprived of their right to a jury trial. The majority opinion pointed to prior holdings that the right to a jury trial extends to statutory claims that are "legal in nature," which the Court then determined the SEC's civil monetary penalties to be, since their purpose is to punish and deter the wrongdoer rather than to make the victim whole.

The implications of this ruling are significant for the securities industry and administrative agencies in general (including, potentially, for Self-Regulatory Organisations, such as FINRA, that have in-house administrative hearing functions). Although the Jarkesy decision itself only concerned the constitutionality of litigating alleged fraud violations before an ALJ, the Supreme Court's reasoning with respect to monetary remedies certainly calls into doubt the ability of the SEC to obtain civil penalties in an administrative proceeding for any violation of the federal securities laws.

As a practical matter, it is expected that the Commission will continue to bring all litigated enforcement matters before federal district court, as it has for several years (with certain narrow exceptions where district courts lack jurisdiction). Any such administrative proceedings likely will be challenged under Jarkesy on Seventh Amendment grounds (as well as on other grounds in the Fifth Circuit's decision on which the Supreme Court did not rule).

Whistleblower Anti-impediment Rules

In January 2024, the SEC ordered J.P. Morgan Securities (JPMS) to pay an USD18 million civil penalty for including a provision in its release agreements with retail clients in which the clients "promised not to sue or solicit others to institute any action or proceeding against JPMS arising out of events concerning" their accounts. Although the agreements expressly permitted JPMS clients to respond to inquiries made by the SEC or any other government or self-regulatory entity, the agreement did not include a provision that expressly permitted clients to voluntarily report information to SEC staff without risking legal action. The SEC determined that the absence of explicit language protecting whistleblowers with respect to the confidentiality requirements was a violation of Rule 21F-17(a) of the Securities Exchange Act of 1934, which prohibits impeding individuals from reporting potential securities law violations to the SEC. Notably, the ruling expands the focus of the SEC's whistleblower protections beyond employees to include investors.

Given this broadening of focus – not to mention the current SEC sweep underway to assess adviser compliance with Rule 21F-17(a) – private equity firms and their holding companies (whether public or private) should review documents across their businesses to make sure that they appropriately carve out whistleblowing activities from their confidentiality and other restrictions. Such documents may include:

- employment-related agreements (eg, employment agreements, separation agreements, confidentiality agreements, restrictive covenant agreements, equity agreements);
- consulting agreements;
- confidentiality agreements/NDAs with individuals;
- policies (eg, compliance manuals; codes of conduct; employee handbooks);
- training materials;
- brokerage customer and advisory client releases/settlement agreements; and
- limited partnership agreements and other forms of investor agreements.

Recent actions underscore the need to avoid even the appearance of impeding whistleblowing through impermissibly restrictive language, conflicting terms, or the lack of explicit whistleblower protections and assurances. Companies also should consult with counsel regarding the most effective way to address any existing or past agreements or other documents that could be read to prohibit or otherwise have a chilling effect on an individual's ability to provide information to or communicate with the SEC or other government agencies.

US Funds Regulatory

The first half of 2024 has seen several important developments in the U.S. regulatory landscape, including the striking down of the Private Fund Adviser Rules and SEC sweeps regarding the Marketing Rule.

Private fund adviser rules vacated

On 5 June 2024, the US Court of Appeals for the Fifth Circuit unanimously struck down the controversial Private Fund Adviser Rules that would have radically changed the SEC's historical disclosure-based approach to the regulation of private fund advisers.

The court's decision was based solely on its holding that the SEC did not have the authority under Advisers Act Section 211(h) and Section 206(4) to promulgate the rules. The court held that Section 211(h) "has nothing to do with private funds" because it applies to "retail customers" only. The court also found that the rules were not supported by the SEC's general antifraud authority under Section 206(4) of the Advisers Act because the SEC had not articulated a "rational connection" between fraud and any part of the rules. Given its holding that the SEC exceeded its authority, the court did not opine on the industry's arguments that:

- the SEC failed to provide the public a meaningful opportunity to comment on the adopted rules;
- the rules are arbitrary, capricious and otherwise unlawful; and
- the SEC did not perform an adequate cost-benefit analysis.

The deadlines for the SEC to seek a rehearing or appeal have passed, but despite the loss the SEC's focus on private funds is likely to continue. The principles behind the rules remain indicative of the SEC's views on many industry practices and potential areas of focus for Advisers Act exams and enforcement going forward. Parts of vacated rules may also continue to surface as investor requests in negotiations, and private fund advisers should be prepared to address investor requests that reflect certain principles underlying the Private Fund Adviser Rules.

The SEC's Spring 2024 Regulatory Agenda includes a target date of October 2024 for final rules with respect to the proposed Cybersecurity Risk Management Rule and Outsourcing Rule, as well as for re-proposing the Predictive Data Analytics Rule, each of which would apply to private fund advisers and relies at least in part on Section 211(h) as authority for the rulemaking. The industry groups that brought the Private Fund Adviser Rules litigation submitted a letter to the SEC encouraging the regulator to withdraw these three proposals, indicating that if adopted they could face similar legal challenges. It is also unclear whether any of the court's conclusions will be read to apply to any existing Advisers Act rules or SEC interpretations.

Marketing Rule

The SEC's Marketing Rule sweep continues to result in enforcement activity. On 17 April 2024, Division of Examinations released a new risk

alert on the Marketing Rule – its third since the rule's 4 May 2021 effective date – which summarises some of the deficiencies observed during the sweep.

The risk alert closely follows the 12 April 2024 announcement of settled charges against five registered investment advisers for Marketing Rule violations. The SEC's orders found that each of the five advisers failed to comply with Marketing Rule requirements by advertising hypothetical performance to the general public on their websites without adopting and implementing policies and procedures reasonably designed to ensure that the hypothetical performance was relevant to the likely financial situation and investment objectives of each advertisement's intended audience. Four of the five registered investment advisors received reduced penalties because of the corrective steps they undertook before being contacted by the SEC staff. The SEC also found that one of the five additionally committed a much longer list of rule violations, including making false and misleading statements in advertisements, advertising misleading model performance, being unable to substantiate performance, failing to enter into written agreements with people it compensated for endorsements, committing recordkeeping and compliance violations, and making misleading statements about its performance to a registered investment company client, which, in turn, were included in such client's prospectus.

The settled charges against those five registered investment advisors were preceded by Marketing Rule-related enforcement actions against nine other registered investment advisers settled in September of last year. Again, the SEC's orders found that each of the advisers advertised hypothetical performance to mass audiences on their websites without having the required policies and procedures. In addition, two of the advisers failed to maintain required copies of their advertisements.

More recently, on 14 June 2024, the SEC settled another Marketing Rule enforcement action against a registered investment adviser, this time for performance advertising that was misleading and not fair and balanced. The adviser was found to have presented performance returns that were experienced by a single investor without disclosing that such investor's elevated performance was due to participation in IPOs in which many other fund investors did not participate. And on 9 August 2024, another registered investment adviser settled an enforcement action relating to its presentation of hypothetical performance on its public website without adopting and implementing policies and procedures reasonably designed to ensure any hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience.

Registered investment advisers are encouraged to review their Marketing Rule policies and procedures in light of these enforcements and the new Risk Alert.

USA – CALIFORNIA

Trends and Developments

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Sidley Austin LLP is a global law firm with 2,300 lawyers in 21 offices situated in key commercial and financial hubs globally. The firm has represented clients in more than 70 countries on complex transactional, investigation, regulatory, and litigation matters. The firm's lawyers and business professionals, fluent in more than 80 languages, possess the cultural awareness and cross-border legal acumen needed to bring clarity to a dynamic business landscape. Sidley has an extensive private equity practice with lawyers around the world principally focused on advising its private equity clients. The firm's private equity lawyers possess deep experience across the broad spectrum of private equity transactions, from multibillion-dollar leveraged buyouts (LBOs) to growth equity investments in premium middle markets companies.

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Private equity (PE) remains a cornerstone of the American financial landscape, driving innovation, growth, and transformation across various industries. As the PE sector in the USA has evolved, so has its legal framework, shaped by regulatory changes, market dynamics, and emerging trends and other issues. This article delves into the latest legal trends and developments in US PE, providing an overview for PE sponsors, investors, issuers, sellers, and legal practitioners.

Regulatory Environment

SEC oversight and enforcement

The Securities and Exchange Commission (SEC) has intensified its scrutiny of PE sponsors. This heightened oversight aims to ensure transparency, fairness, and investor protection. Recent enforcement actions against PE sponsors have focused on issues such as fee disclosures, conflicts of interest, and valuation practices. The SEC's Division of Examinations continues to prioritise examinations of PE sponsors, particularly regarding compliance with the Investment Advisers Act of 1940 and environmental, social and governance (ESG) disclosures. PE sponsors must navigate this evolving regulatory landscape, including balancing ESG objectives with fiduciary duties to investors.

Increased antitrust scrutiny

The regulatory environment for PE is also being shaped by increased antitrust scrutiny. The Federal Trade Commission (FTC) and the Department of Justice (DOJ) as well as foreign antitrust agencies have become more vigilant in examining mergers and acquisitions that could potentially reduce competition. This is particularly relevant for PE sponsors engaged in roll-up strategies where smaller companies are consolidated to create a larger combined entity. These federal and foreign agencies are now more focused on whether these roll-ups could lead to monopolistic behaviour or harm to consumers. As a result, PE sponsors must carefully assess antitrust risks during the due diligence and transaction documentation process and be prepared for potentially longer review periods and more stringent requirements for divestitures and/or other remedies in connection with acquisitions and sales of portfolio companies.

Anti-Money Laundering (AML) and Know Your Customer (KYC) Requirements

PE sponsors are increasingly subject to stringent AML and KYC regulations. The Anti-Money Laundering Act of 2020 expanded the related US regulatory framework, requiring PE sponsors to implement robust compliance programs. This includes comprehensive customer due diligence and ongoing monitoring to detect and prevent illicit activities. The Corporate Transparency Act of 2024 was subsequently enacted to require certain types of entities to file a beneficial ownership information report with the Financial Crimes Enforcement Network, a bureau of the United States Department of Treasury. The emphasis on AML and KYC compliance is part of a broader regulatory effort to combat financial crimes and ensure that PE investments do not facilitate money laundering or terrorism financing. Compliance programs must be continuously updated to reflect evolving threats and regulatory expectations, and PE sponsors should conduct regular training to ensure that all employees are aware of their applicable legal obligations.

Committee on Foreign Investment in the United States (CFIUS)

CFIUS plays a critical and larger role in the regulatory landscape for PE, particularly concerning national security. Recent amendments to the CFIUS regulations have expanded the scope of transactions subject to review, including certain

non-controlling investments in critical technology, infrastructure, and data companies. PE sponsors involved in cross-border transactions must be aware of these regulations as well as related foreign direct investment regulations in other jurisdictions and conduct thorough national security assessments where appropriate during the due diligence and transaction documentation process. Compliance with CFIUS and foreign direct investment requirements can be complex and time-consuming, necessitating the involvement of experienced legal counsel to navigate the process effectively with the White House and applicable federal and foreign agencies in PE acquisitions and dispositions.

Non-competition restrictions and legal challenges

Earlier this year, the FTC adopted a rule prohibiting most post-employment non-competition agreements in the USA. While this rule is subject to many lawsuits with respect to its constitutional and statutory authority, it includes an exemption with respect to non-competition agreements entered into in connection with the sale of a business. PE sponsors are co-ordinating with legal advisors to keep up with the status of such legal challenges and structure non-competition and other similar agreements to comply with such rule and related exemption.

Changes in Delaware Law

Earlier this year, the Delaware Court of Chancery held that provisions of a stockholder agreement that included a stockholder pre-approval requirement prior to permitting certain company board actions and imposed various other obligations and restrictions on the board were invalid and unenforceable. This ruling caused significant concern among PE sponsors because it called into question the enforceability of stockholder agreements commonly entered into by PE sponsors and their Delaware corporation portfolio companies. In response to these and other concerns, the Delaware legislature passed (and the Delaware governor signed into law) an amendment to the Delaware corporate law that generally overturned such ruling and permits stockholders agreements as long as the agreement does not violate the company's charter and would not violate Delaware law if included in the charter.

Market Dynamics

Increased cost of debt financing

The cost of debt financing has risen, influenced by changes in monetary policy and economic conditions. Higher interest rates and tighter lending standards have made it more expensive for PE sponsors to leverage buyouts and other investments, which has decreased PE M&A deal volume and resulted in valuation mismatches between PE sponsors and sellers. This has significant implications for PE deal structuring, as PE sponsors must balance the need for leverage with the increased cost of capital. Additionally, higher debt costs affect the overall returns on investments and require PE sponsors to explore alternative financing strategies or seek out opportunities with higher growth potential to justify the increased expenses. These trends and developments have led to many PE sponsors to focus on direct lending strategies to companies (including other PE portfolio companies) in order to take advantage of higher interest rates in circumstances where traditional banks are not able to lend.

Increased competition

The PE market has witnessed a surge in competition, driven by abundant capital and a robust fundraising environment. This competition has led to more aggressive deal-making by PE sponsors that are constantly fundraising, deploying

capital and seeking investment exits. PE sponsors must navigate these dynamics, balancing the need for attractive returns with the risks of overpaying for assets. The influx of new market entrants, including family offices and sovereign wealth funds, has intensified the competitive landscape. To differentiate themselves, PE sponsors are increasingly focusing on value creation strategies post-acquisition, such as operational improvements and strategic add-ons, to enhance the performance of their portfolio companies. PE sponsors are also focusing on late stage growth equity as an asset class to broaden their investment scope and seek attractive valuations and returns.

Secondary market growth

The secondary market for PE interests has grown substantially. This trend is driven by the need for liquidity among investors and the desire to rebalance portfolios. The legal landscape surrounding secondary transactions is evolving, with a focus on disclosure, valuation, and transfer restrictions. PE sponsors must navigate these complexities to ensure smooth and compliant transactions. Secondary market transactions offer flexibility for limited partners (LPs) seeking to exit investments before the end of the fund's life cycle. However, these transactions also require careful management of investor relations and adherence to fund agreements and regulatory requirements.

Special Purpose Acquisition Companies (SPACs)

SPACs have declined as a significant force in the PE market. These blank-check companies provide an alternative route to public markets, offering flexibility and speed. However, the SEC has increased scrutiny of SPACs focusing on disclosure practices, conflicts of interest, and the adequacy of due diligence which has substantially decreased the volume of SPACs as well as PE sponsors' interest in SPAC transactions as a portfolio company exit strategy.

Legal Trends

M&A deal terms

In the current market, M&A deal terms are evolving to address heightened competition and regulatory scrutiny. Some PE sponsors have been "jumping" competitive auctions by submitting bids prior to auction deadlines subject to relatively short confirmatory due diligence to get ahead of other bidders. Certain larger PE sponsors have eliminated the uncertainty surrounding debt financing by offering targets "full equity backstop" commitment letters under which targets can compel such funds to pay the entire purchase price once the applicable closing conditions are satisfied, which has favoured larger PE sponsors in auctions over their smaller counterparts who cannot offer such terms due to fund concentration limits. In private M&A transactions, there has been an increased use of earnouts, where a portion of the purchase price is contingent on the future performance of the acquired business, to help bridge valuation gaps between buyers and sellers and aligns interests. Finally, there is a growing emphasis on representations and warranties insurance (RWI) to mitigate risks associated with breaches of representations and warranties. RWI policies provide buyers and sellers with a mechanism to cover potential liabilities, facilitating smoother negotiations and reducing the need for extensive indemnity provisions. PE sponsors must carefully consider these evolving deal terms to navigate the complexities of M&A transactions effectively.

Fund structuring and terms

Innovations in fund structuring continue to shape the PE landscape. There is a growing

trend towards bespoke fund structures tailored to the specific needs of investors. This includes the increased use of continuation funds, which allow PE sponsors to extend their investment horizons and provide liquidity to existing investors, and related restrictions on use of continuation funds by co-investors of PE sponsors in portfolio companies. Additionally, terms related to management fees, carried interest, and hurdle rates are evolving to align interests between fund managers and investors. PE sponsors are increasingly adopting flexible fee structures, such as tiered management fees that decrease as the fund size increases or increase as certain performance milestones are achieved. These innovations aim to enhance alignment and attract a broader range of investors.

Co-investments and syndications

Co-investment opportunities have become increasingly popular among LPs. These arrangements allow LPs to invest alongside the main fund, often with reduced fees and improved terms. Legal considerations include the structuring of co-investment vehicles, disclosure of conflicts of interest, and alignment of incentives. PE sponsors must carefully navigate these issues to maintain strong LP relationships and meet regulatory requirements. Co-investments offer LPs the opportunity to increase their exposure to attractive deals while maintaining a close relationship with the PE sponsor. However, managing co-investment opportunities requires clear communication, transparency, and a thorough understanding of the legal and regulatory implications.

Digital transformation and cybersecurity

The digital transformation of PE operations is a significant trend. PE sponsors are leveraging technology to enhance deal sourcing, due diligence, and portfolio management. However, this digital shift brings cybersecurity risks. Legal considerations include data protection, incident response planning, and compliance with cybersecurity regulations that are constantly changing around the world including in each state in the USA. PE sponsors must implement and continually update robust cybersecurity measures to protect sensitive information and maintain investor confidence. The increasing reliance on technology also necessitates the adoption of best practices for data governance and cybersecurity hygiene. PE sponsors should regularly assess their cybersecurity posture, conduct vulnerability assessments, and invest in employee training to mitigate risks and comply with new regulations effectively.

Emerging Issues

Artificial intelligence

Artificial intelligence (AI) is increasingly being integrated into PE operations, offering new opportunities for efficiency and value creation. AI is being used by PE sponsors to enhance deal sourcing by analysing vast amounts of data to identify potential investment targets and trends. Additionally, AI-powered analytics are improving due diligence for PE sponsors by providing deeper insights into a target company's financial health, operations, and market positioning. However, the use of AI also raises many legal considerations, including data privacy, algorithmic bias, and compliance with evolving regulations in numerous areas. PE sponsors must navigate these challenges to harness the full potential of AI while ensuring legal compliance.

Presidential election and wars in Israel and Ukraine

Political and geopolitical events, such as the upcoming US presidential election and conflicts like the ongoing wars in Israel and Ukraine, significantly impact the PE landscape. Changes in

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government policies, regulatory priorities, and economic stability influence market dynamics and PE investment strategies. For instance, shifts in tax policies, trade agreements, and foreign investment regulations significantly affect PE deal structuring and cross-border transactions. Additionally, geopolitical conflicts introduce uncertainties and risks that require careful consideration in the PE due diligence process and strategic planning. PE sponsors are closely monitoring these developments and assessing their potential impact on their current and potential investments.

Focus on diversity and inclusion

Diversity and inclusion (D&I) have become critical considerations for PE sponsors. There is increasing pressure from investors, regulators, and stakeholders to improve D&I practices within PE sponsors and their portfolio companies. Legal considerations include the implementation of D&I policies, compliance with anti-discrimination laws, and the incorporation of D&I metrics in performance evaluations. PE sponsors are prioritising D&I to enhance their reputation and attract top talent. Efforts by PE sponsors to improve diversity include setting measurable goals for diverse representation, implementing bias training programs, and fostering an inclusive culture that supports the career advancement of under-represented groups.

Cross-border transactions

Cross-border PE transactions are becoming more prevalent and present unique legal challenges that continue to shift. These include compliance with changing international regulations, navigating complex tax structures with new laws, and managing shifting geopolitical risks. The evolving global landscape, including trade tensions and regional conflicts, adds complexity to cross-border deals. PE sponsors must stay informed about international developments and work with experienced legal counsel to navigate these transactions successfully. In addition to regulatory compliance, cross-border deals require careful consideration of cultural differences, local market dynamics, and potential legal disputes. Effective cross-border transaction management involves thorough due diligence, strategic risk mitigation, and collaboration with local advisors to ensure successful outcomes.

Best Practices for Legal Compliance

Robust compliance programmes

To navigate the complex and changing legal landscape, PE sponsors must implement robust compliance programmes. This includes regular training for employees, comprehensive internal policies, and ongoing monitoring and auditing. A strong compliance culture can mitigate risks and enhance operational efficiency. Effective compliance programmes should be tailored to the PE sponsor's specific risks and regulatory environment, incorporating best practices and lessons learned from previous regulatory actions. Regularly updating and reviewing compliance policies, conducting internal audits, and fostering a culture of compliance are essential components of a robust compliance framework.

Proactive regulatory engagement

Proactive engagement with regulators is essential for PE sponsors. This includes participating in industry consultations, staying informed about regulatory changes, and maintaining open lines of communication with regulatory bodies. By engaging proactively, PE sponsors can influence policy development and ensure compliance with evolving regulations. Building constructive relationships with regulators can also facilitate a better understanding of regulatory expectations and reduce the risk of enforcement actions. PE

sponsors should consider appointing dedicated regulatory affairs professionals or external advisors to manage regulatory interactions and stay ahead of emerging regulatory trends.

Emphasis on transparency

Transparency is a key component of legal compliance in the PE sector. PE sponsors must prioritise clear and accurate disclosures to investors, regulators, and other stakeholders. This includes transparent fee structures, conflict of interest disclosures, and comprehensive ESG reporting. Enhanced transparency builds trust and strengthens relationships with stakeholders. Transparency initiatives should extend beyond regulatory requirements to encompass all aspects of the PE sponsor's operations, from investment strategies to portfolio company performance. By fostering a culture of transparency, PE sponsors can enhance their reputation, attract capital, and mitigate the risk of regulatory scrutiny.

Frequent communication with legal counsel on changing regulatory landscape

Frequent communication with legal counsel is vital for PE sponsors to navigate the changing regulatory landscape. Legal counsel can provide valuable insights into new regulations, enforcement trends, and emerging legal risks. Regular consultations with legal advisors can help PE sponsors stay informed and proactively address potential compliance issues. This communication should be integrated into the PE sponsor's overall compliance strategy, ensuring that legal counsel is involved in decision-making processes and has a comprehensive understanding of the PE sponsor's operations and risk profile. By maintaining close collaboration with legal advisors, PE sponsors can better anticipate and respond to regulatory changes, reducing the risk of non-compliance and enhancing overall legal resilience.

* * *

The PE landscape in the USA is dynamic and evolving, shaped by regulatory changes, market dynamics, and emerging trends. PE sponsors, investors, issuers, sellers and legal practitioners must stay informed about the latest developments and proactively address legal challenges. By implementing robust compliance programmes, engaging with regulators, prioritising transparency and communicating with legal counsel on regulatory changes, PE sponsors can successfully navigate the complex and constantly changing legal landscape and drive sustainable growth. As the PE sector continues to evolve in the USA, staying ahead of legal trends and developments will be crucial for success.

USA – MARYLAND

Trends and Developments

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Duane Morris LLP has over 900 attorneys in offices across the United States and internationally and provides innovative solutions to today's legal and business challenges to a broad array of clients. The firm possesses deep industry knowledge and focus in key business sectors, including financial services, education/EdTech, technology, health/life sciences, infrastructure, and consumer products, and is ranked as a top law firm for exceptional client service. Recognised as a middle-market leader, the firm's private equity and private credit lawyers advise sponsors on complex equity and debt investments, M&A, fund formation and regulatory matters. Duane Morris advises both GPs and LPs regarding co-investment, direct investment and secondary transactions. For sponsor-backed companies, the firm works with management teams on a wide range of issues, including M&A and capital formation, tax matters and business operations and strategy.

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Introduction

The private equity ecosystem has shown signs of life in recent months. The market, like many others, had its fair share of struggles since the highs of 2021-22, throughout the entirety of the private equity life cycle, from fundraising to exit. While there is a sense of guarded confidence that the light at the end of the tunnel is approaching, the question remains whether recent improvements in the private equity landscape are sustainable.

Fundraising

Over the past several years, sponsors have faced challenging fundraising conditions in the market due to multiple factors – most importantly, a series of eleven interest rate increases beginning in March 2022 and culminating in July 2023. The net result was an aggregate increase in the Federal Reserve rate range from 0.00%-0.25% as of March 2022 to a rate range of 5.25%-5.50% by July 2023.

Those efforts, for the most part, have yielded the Federal Reserve's intended results of substantially curbing inflation but have also had a collateral chilling effect on private equity fundraising. The Bureau of Labor Statistics report released in August 2024 shows that inflation fell to -0.1% in June, its lowest monthly growth rate since May 2020, with yearly inflation currently at 2.9%. This represents a drastic decrease from peak inflation of 9.1% in June 2022 and is approaching the target of 2.0%. In response to the cooling of inflation rates and the increase of the US unemployment rate to a three-year high of 4.3%, the Federal Reserve has announced that it anticipates cutting interest rates in 2024. Recent market predictions estimate a 0.5% rate cut in September followed by subsequent cuts culminating in total interest rate cuts of 2.25% by the end of 2025. If the anticipated interest rate cuts come to fruition, they stand to spur M&A transactions beginning in Q4 of 2024 and continuing throughout 2025, which should yield an increase in fundraising for fund sponsors and meaningfully reinvigorate the private equity market.

As fund sponsors face slow fundraising environments, many sponsors endeavour to close in new vintages of funds with a core number of anchor (and often repeat) investors. As it currently stands, the majority of capital raised in the first half of 2024 was concentrated in a handful of the largest private equity funds, many of which were buyout funds, placing smaller fund sponsors in an extremely competitive fundraising environment and enhancing the negotiating leverage of potential investors. However, emerging and mid-market funds have begun to adapt by employing innovative marketing strategies, specialising in niche market segments, entering into strategic alliances, and offering more investor-friendly terms.

Unlike the large, diversified funds, emerging funds and mid-market funds are nimble and flexible. They have fewer investors than their larger competitors, which enables them to specialise and tailor their structure and terms to specific groups of investors. These funds offer investors the ability to concentrate on undercapitalised market segments poised for growth, such as specialty service providers, data centres and physician groups. They also have increased flexibility to negotiate investor-friendly terms – for instance, shorter investment periods, more definite fund terms, increased financial information reporting, and enhanced data on portfolio companies' environmental, social and governance strategies.

The market conditions have also facilitated the rise of hybrid funds, which share elements of

closed-ended private equity funds and open-ended hedge funds. Hybrid funds are highly individualised structures, each with differing investment strategies and terms. However, they share certain key characteristics, such as allowing investors to redeem existing investments or add capital during the life of the fund at regular intervals or on the occurrence of certain, specified events, an attractive liquidity feature.

Despite overall positive outlook of the private equity market for the remainder of 2024 and into 2025, regulatory burdens exist that present fundraising challenges. Last year, the SEC aggressively enforced the Marketing Rules, which no doubt will impact sponsors' future marketing efforts and, accordingly, capital raised.

Fund Finance

Sponsors have also faced tough times in other aspects of the private equity market in addition to fundraising, including the fund finance arena. The disruption caused by regional banking failures of 2023 continues to have an impact on the fund finance market for banks, sponsors and investors alike. The bank pullback that resulted from the failures of Silicon Valley Bank, Signature Bank, and First Republic Bank accelerated the rapid expansion of private credit lending sources in the fund finance market, with private credit lenders now accounting for nearly one quarter of all loans in the fund finance space. Many institutional lenders restructured where fund finance fits into their organisation and some previously involved lenders have exited the fund finance market entirely in the last few years. This transition has left space for other lenders (especially non-bank and non-US lending entities) to enter into or expand their footprint in the fund finance lending market. Many of these new entrants use syndicated fund finance deals to get a foot in the door to develop relationships with fund sponsors. However, lower utilisation on fund lines of credit is hindering bank-led syndications and as a result, anchor lenders have started to look for smaller holds and deals that may produce future accordion expansion.

While the increasing presence of repeat investors across fund vintages signals reliability and helps lenders with the underwriting process, lenders (both institutional and non-bank) reevaluate concentration limits and exposure to the same fund sponsors, individual investors, and even portfolio companies across their active and potential new loans. Further, lenders are adjusting their risk profiles and looking to mitigate risks tied to smaller/more concentrated investor bases at the outset of loans, which has led to some requiring seeding capital calls before initial credit extensions, clean-down provisions, lower threshold percentages of defaulting investors that can trigger events of default, and covenants/defaults related to poor fund performance (especially for funds with longer-term investment strategies).

Additionally, in the face of relatively high interest rates and then-existing uncertainty as to rate cuts, fund sponsors are looking to right-size facilities, reduce tenors of facilities, and diversify exposure to one or two depository institutions, while increasing flexibility and offerings. Interest in NAV facilities (and subscription backed/NAV hybrids) remains high and there is growing discussion and interest in rated feeder and collateralised fund obligation structures. Lenders (institutional and non-bank) and sponsors are working together to create flexible and innovative product offerings in view of potential regulatory changes and ongoing changes in the market.

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Rise in Private Credit

Private credit serves as a lending solution for middle market companies deemed too large or too risky by commercial banks and too small for public markets. As noted above in the fund finance context, this was especially true in 2023, which saw banks tighten their lending standards and shift their focus to customer deposits after Silicon Valley Bank's collapse in March. Private credit filled the void by making loans that banks otherwise would not, and private credit assets grew from around USD1.8 trillion globally at the end of 2022 to approximately USD2.1 trillion by the end of 2023. The increase in assets annually from 2020 to 2023 has outpaced the growth of private credit in prior years. Private credit has even outpaced private equity in performance over the past couple of years. According to The Wall Street Journal, private credit strategies have delivered a cumulative return of 15.5% from 1 January 2022 through 31 March 2024, compared to private equity's -1.3% over the same period, highlighting the resilience of private credit in volatile markets and its ability to generate consistent income streams.

In addition to increased availability, private credit generally offers companies three main advantages over bank loans:

- flexibility in terms;
- speed in execution; and
- confidentiality.

In terms of flexibility, banks typically require cash interest payments beginning the month after loans close and are less likely to negotiate financial covenant definitions. Private credit often allows companies to capitalise all or a portion of the interest accruing on a loan (providing for payment-in-kind interest), and tailor financial covenant definitions to that company's assets and operations. Private credit also commonly includes a small number of investors, which provides for direct and more efficient negotiations of loan terms in contrast to broadly syndicated bank-led deals that feature large pools of lenders that must approve changes in loan terms. Lastly, private credit offers a higher degree of confidentiality over a company's financial information than bank loans, in which rating agency reports and trade publication releases may include unnecessary disclosures.

M&A Climate

Although private equity M&A had a slower-than-anticipated start to the year, recent developments indicate a strengthening market with encouraging signs of a recovery ahead. Based on data compiled by S&P Global Market Intelligence, the first half of 2024 saw 6,066 private equity deals totalling USD309.82 billion in value, reflecting a 24% increase in deal value but an 8% decrease in deal volume in comparison to the first half of 2023. While an improvement from 2023, at least in terms of value, private equity M&A activity is still far off the highs of prior years. By way of comparison, the first half of 2021 saw 9,619 deals totalling USD578.43 billion in value, and the first half of 2022 saw 9,722 deals totalling USD459.89 billion in value. Despite ongoing factors like inflationary pressures, high interest rates and geopolitical uncertainties contributing to lower levels of deal activity, there is cautious optimism among experts that M&A activity will ramp up in late 2024 and into 2025.

Headwinds Affecting Dealmaking

Some of the headwinds affecting private equity M&A include high inflation, high interest rates, and geopolitical uncertainties.

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Inflation

Inflation trajectories impact the timing, structure, and financing of M&A. As noted above, inflation spiked coming out of the COVID-19 pandemic, with a peak at 9.1% in June 2022, but inflation rates are stabilising, with the current rate at 2.9%. Assuming no additional macroeconomic shocks or geopolitical crises in the near future, economists believe that inflation will continue to stabilise but generally doubt that the Federal Reserve's target of 2% will be reached by the end of 2024. Decreasing inflation rates could lead to a decrease in the cost of goods and services and increase in valuations, which could generate more M&A activity in the near future.

Interest rates

High interest rates make it more difficult to secure financing at attractive rates, hindering growth and restricting the practicality of utilising debt as a funding source. As noted above, due to the significant increase in inflation in 2022, the Federal Reserve raised interest rates in an effort to reduce inflation. Despite the Federal Reserve's decision not to cut rates in July 2024, the Federal Reserve is expected to lower interest rates in the coming months. Even a minor decrease in interest rates would reduce borrowing costs and permit more attractive financing options, thus supporting an increase in deal activity.

Geopolitical uncertainties

2024 is a major election year for 64 countries around the world. As a result, the economy faces uncertainties in connection with policy and regulation. The US presidential election is of chief concern for US-based private equity firms, as the administration that ultimately prevails will direct economic and foreign policy plans and regulatory framework for the next four years. Market volatility and hesitation among firms to engage in deals may persist with elections ongoing, especially in sectors particularly vulnerable to the effect of the election. Thus, firms need to be proactive in assessing potential risks and strategically plan transaction timelines.

Global conflicts have further negatively impacted the deal market. Instability in the Middle East and the ongoing war between Russia and Ukraine have been especially detrimental to the energy sector and created global supply chain issues in connection with food products, critical minerals, and other commodities. Additionally, worsening relations between the USA and China have exacerbated concerns about global economic deceleration, particularly through heightened trade tensions, tariff disputes, and disrupted supply chains. In light of these geopolitical uncertainties, private equity firms may be taking a more cautious stance on investments in affected industry sectors.

Industry Sector Implications

Certain industry sectors have been more susceptible to headwinds than others. The commercial real estate sector is particularly stagnant, with offices and warehouses not faring well due to the shift to remote/hybrid work environments following the COVID-19 pandemic and higher construction costs driven by increased prices for building materials. Similarly, the retail and consumer goods sectors have been adversely affected by ongoing supply chain disruptions, higher product prices, and reduced consumer spending. The raw materials sector has also seen reduced deal volume and value as private equity firms hold out for more profitable conditions.

Other industry sectors, however, have fared better. Of the 35 megadeals announced this year, the technology and energy sectors are leading the way, with significant M&A activity also in

healthcare and life sciences, financial services, and industrial manufacturing. Economists anticipate that the technology sector will continue to flourish due to transformative developments in emerging technologies and artificial intelligence. The energy sector is also expected to remain a key player in dealmaking due to the global push for clean and renewable energy sources, such as solar and wind. Growth in the healthcare and life sciences sector has been fuelled by technological advancements, scientific breakthroughs, and new drug developments. The financial services sector is active due to trends in digitisation and the emergence of new technologies, including cryptocurrency and blockchain. M&A in the industrial sector has had a particular emphasis on acquisitions designed to enhance software and data services revenue, especially in the automotive, aerospace, and industrial equipment subsectors.

Types of Deals Anticipated

Before the COVID-19 pandemic, private equity firms' investments historically demonstrated a 75-25 ratio with respect to deal volume between platform deals and add-on acquisitions, respectively. Add-ons, bolt-ons, and tuck-ins have become more attractive due to their reduced complexity and more accessible financing, and firms have been pursuing add-ons in the current environment to strengthen their current portfolio companies, with the goal of increasing value through strategic growth before exiting. This shift in focus has resulted in a new 50-50 balance between platform deals and add-on acquisitions.

Private equity firms have also moved toward a preference in acquisitions of companies from the middle and lower-middle markets in an effort to navigate the barriers posed by elevated borrowing costs. Middle-market private equity deals in the USA have grown from representing 45% of the total private equity volume in 2021 to 53% in 2023. These smaller-scale companies offer a more precise evaluation, quicker post-acquisition integration, and opportunities to fill gaps in private equity portfolios.

In a leveraged buyout, where the objective is to maximise investment returns by covering a significant portion of the purchase price with borrowed funds, debt typically constitutes a majority of the acquisition cost. However, unfavourable financing conditions and elevated borrowing costs have made securing large loans more challenging and expensive, leading some private equity firms to adopt a more equity-heavy capital structure. Less leverage can diminish the potential for higher returns on investment and put more equity capital at risk, resulting in lower EV/EBITDA multiples and more conservative deal valuations. To navigate the new financial landscape of reduced leverage and potentially lower expected returns, private equity firms may extend holding periods and explore alternative exit routes to maximise value and achieve more optimal returns.

The M&A market has recently seen a rise in deals financed by alternative providers. Just as in other areas of funding needs, private credit firms, in particular, have stepped in for traditional bank lenders, funding 85% of private equity M&A transactions in 2023, up from 41% in 2021 and 59% in 2022. As interest rates stabilise toward the end of 2024, borrowing costs are expected to become more favourable, which would make leveraged buyouts and other debt-financed investments once again more attractive to private equity firms. In response to the increased demand, traditional bank lenders may try to take back some of the ground ceded to private credit firms. Competition between bank lenders and

alternative credit providers may influence the availability of credit and the terms of loan offerings for the benefit of sponsors in the private equity M&A market.

Amid ongoing economic challenges, distressed companies are focusing on restructuring their operations to enhance efficiency and profitability. This drive for restructuring has led to a rise in distressed asset sales, as companies seek to reduce leverage and generate cash flow. Consequently, private equity firms may capitalise on this trend by acquiring undervalued assets at attractive price tags. By doing so, they not only position themselves for substantial returns but also emerge as instrumental in revitalising struggling businesses and advancing broader market recovery.

The last few years have also been notable for robust activity in strategic transactions for funds, commonly known as secondaries. Secondaries have gained popularity due to the flexibility they offer sellers seeking to liquidate or rebalance their portfolios. Buyers benefit from potentially faster returns on capital, discounted access, and increased transparency into the underlying assets or portfolio. The opportunity to sell stakes before a private equity fund's life cycle ends is particularly advantageous, considering that investments typically have holding periods of seven to ten years under current market conditions, up from the previous norm of five to seven years. Reports indicate that transaction volume in the secondaries market reached USD114 billion in 2023, a 10% increase from the USD103 billion volume in 2022. These transactions continue to prove successful, surpassing USD72 billion within the first six months of 2024. At this rate, secondaries are expected to become a key transaction vehicle to ride out market volatility.

With the economic downturn and a decline in platform investments, firms have stockpiled dry powder, accumulating an unprecedented amount of approximately USD3.9 trillion over the last four years. This substantial capital reserve may drive a surge in acquisitions by private equity firms eager to deploy funds to secure long-term returns for investors. Further, headwinds are beginning to dissipate, revealing clearer skies on the horizon. Economists anticipate inflation to cool, interest rates to gradually decrease, and ongoing geopolitical uncertainties to settle in due time. Moving into the fourth quarter of 2024, there is cautious optimism for an increase in M&A activity and an improved overall private equity market.

USA – NEW YORK

Trends and Developments

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Wachtell, Lipton, Rosen & Katz

Wachtell, Lipton, Rosen & Katz was founded on a handshake in 1965. It operates from a single New York office, regularly handling many of the largest, most complex and demanding transactions in the United States and around the world. The firm counsels both public and private acquirors and targets, advising on mergers, acquisitions, LBOs, divestitures, restructurings and liability management transactions, across many industries and of any description. Recent representations include: Apollo in its USD1.85 billion acquisition of U.S. Silica; Broadcom in the USD4 billion sale of its End-User Computing Division to KKR; FIS in the sale of a majority stake in its USD18.5 billion Worldpay business to GTCR; eBay in the USD14 billion acquisition of Adevinta by a consortium led by Permira and Blackstone; Searchlight Capital in its USD3.1 billion acquisition, together with BCI, of Consolidated Communications; and T-Mobile in its joint venture with KKR to acquire Metronet.

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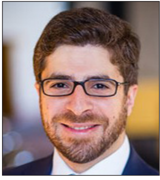

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Private equity (PE) investors and dealmakers have faced headwinds since the COVID-era boom of 2021 – including higher interest rates, persistent inflation, widely divergent valuation expectations, market and geopolitical upheavals and heightened regulatory scrutiny. And 2024 has so far presented a continuation of many of these challenges.

But adversity is the crucible of innovation, and although the volume of PE buyouts remains down from its post-COVID peak, sponsors have been deploying creative approaches to fill financing gaps, navigate uncertainty and get deals done. What follows is an overview of key trends and developments in the PE space of late.

Acquisitions and Exits

Buyouts stall, for now

Private equity deal volumes have continued their decline from their pandemic heights. Deal volumes for the first six months of 2024 annualise to approximately USD1.2 trillion, in line with 2023 and a decline from USD1.7 trillion in 2022 and a record USD2.2 trillion in 2021. The continued stall, however, comes amidst broader challenges facing M&A generally; private equity's share of overall M&A deal volume for the first half of 2024 (33%) was above both first-half and full-year 2023 levels (32% and 30%, respectively) and only modestly below full-year 2022 and 2021 levels (both 35%). Persistently elevated interest rates, valuation fundamentals and the "expectations gap" between sellers and buyers all deserve their due for the continued M&A slowdown.

In this environment, sponsors have had to be creative and nimble in identifying opportunities and structuring deals – and with some examples of success. So far, 2024 has seen 11 US deals larger than USD5 billion, as compared to five for the same period in 2023. The technology sector in particular continues to be one of the more robust sources of private equity activity, as debt funds continue to be willing to provide moderate but important leverage to "recurring-revenue" software businesses. The first half of 2024 saw a number of multi-billion-dollar tech take-privates, despite stock markets reaching record highs powered in large part by tech outperformance.

Growing pressure for exit options

Many of the headwinds on the buy-side are a double-edged sword, with implications for the sell-side. With M&A activity somewhat muted and the IPO markets only just beginning to thaw, sponsors have seen diminished opportunities to exit on attractive terms. Global private equity exits for 2024 are annualising to approximately USD610 billion, off from USD731 billion in 2023 and USD773 billion in 2022, and well below the pandemic high of USD1.7 trillion in 2021. Sponsor-to-sponsor sales also hit a 10-year low in the first half of 2024. This dearth of exit opportunities has led to a meaningful backlog in private equity deal pipelines. Over 30% of portfolio companies have been held for 5-plus years, an increase from approximately 22% in 2021. And private equity firms globally now hold a record 28,000 unsold companies, collectively worth more than USD3 trillion, according to recent reports.

Continuing a trend of the past several years, the secondary market has accordingly remained a popular alternative path to monetisation, with continuation funds accounting for an increasingly sizable share of sponsor-initiated secondary deal volume. The asset class received a major boost from the USD18.3 billion announced sale of SRS Distribution to Home Depot, which took place mere months after Leonard Green rolled a partial stake in the company into a continua-

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tion pool. A diversified group of alternative-asset managers have been observed moving capital and fundraising into these areas, continuing to validate them as properly part of the core private equity market.

Everything old is new again – sponsors pooling capital with each other, and with activists

Private equity "club deals," a hallmark of the pre-2008 era, but a relatively uncommon feature in the decade that followed, are another example of the ways in which sponsors have been working harder and digesting more complexity to get deals done in this environment. Major recent examples include the USD13 billion acquisition of eBay-backed Adevinta by a consortium of investors led by Permira and Blackstone; the USD15.5 billion buyout of Truist Insurance led by Stone Point and Clayton, Dubilier & Rice; and Goldman Sachs's sale of GreenSky to an investor group led by Sixth Street. Some sponsors have expressed reluctance to participate in mega club deals, citing the challenges to exit presented by the muted buy-side appetite and lukewarm reception some PE-backed listings have faced in the public markets. That said, club deals offer sponsors a means of diversification and access to bigger targets, and it is expected they will continue to be a tool used by PE shops in the right situations.

And as in previous years, traditional activists participated in several high-profile club deals, as sponsors showed a continued willingness to partner both with each other and with other classes of investors. Examples include the USD7.1 billion acquisition of Syneos Health by an Elliott-led consortium that included Patient Square Capital and Veritas Capital, and Apollo's USD5.2 billion acquisition of Arconic, which included a minority investment from Irenic Capital Management.

Deal Financing

Higher rates = higher equity checks; private credit remains a force; syndicated markets make H1 2024 comeback

The sustained high-rate interest environment, and the on-again, off-again HY markets of the last two years, have had a major impact on PE dealmaking. Average leverage levels for new leveraged buyouts (LBOs) declined to 5.9 times in 2023 from 7.1 times in 2022, and the average equity contribution for large LBOs exceeded 50% in 2023, an all-time high.

Direct lenders have come to dominate small- and mid-market PE financings, and as direct lender funds get increasingly larger, their capacity to finance large-scale PE grows as well. In 2023, 86% of loans for LBOs were made by direct lenders (compared with 65% in 2021). The trend continued through the first quarter of 2024, with private credit financing 85% of LBOs, and only 15% of sponsors tapping the syndicated market.

US institutional loan market activity overall reached multi-year highs in the first quarter of 2024, with repricing and refinancing transactions predominating. The bounceback of syndicated markets did create openings for banks to provide leveraged loans in LBO transactions, however. Notable examples include KKR's acquisition of a 50% stake in healthcare analytics provider Cotiviti (supported by USD5 billion in loans from a bank group led by JPMorgan) and the USD15.5 billion buyout of Truist Insurance mentioned previously (funded by a debt package of over USD9 billion, including more than USD6 billion in BSLs).

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In addition to pitching traditional syndicated deals, some banks have begun an "if you can't beat them, join them" approach to direct lending. In 2023, Wells Fargo announced a strategic relationship with Centerbridge Partners and Société Générale announced a global partnership with Brookfield, while others, including JPMorgan, are reported to have set aside significant amounts of their own capital for direct lending efforts. JPMorgan is also reportedly seeking to buy a private credit firm to augment its USD3.6 trillion asset management arm, and Goldman Sachs has announced that its alternative investments arm has raised more than USD20 billion for direct lending to private equity.

The blurring of lines between "traditional" and alternative lending is expected to continue, as alternative asset managers expand both their reach and their own funding sources, while traditional banks work to win back share through both syndicated deals and their newly-minted direct lending offerings. For sponsors and borrowers, the right financing solution will depend on market conditions and deal specifics. Many PE financing processes today include a "grid process" that involves outreach to both direct lenders and traditional banks – it is anticipated this will very much remain the "new normal."

A sharp-elbowed financing market – debt default activism in the higher rates environment

In response to post-COVID interest rate hikes, acquirers have used creative strategies to keep low-rate debt of target companies in place following an acquisition. But just as a high interest rate environment makes existing low-rate debt more valuable to borrowers, it also makes such debt more of a burden to lenders. Borrowers have resultantly seen a meaningful increase in "debt default activism," with creditors deploying legal arguments and maneuvers to seek to force borrowers to refinance existing low-rate debt on new market-rate terms. The current sharp-elbowed financing markets encourages sponsors structuring corporate transactions that leave low-rate debt in place to build a record with defence in mind and carefully review not only obviously applicable provisions in debt documentation, but also those that might seem like insignificant "boilerplate."

Liability management booms

Sustained higher interest rates and challenging financing markets, coupled with increased sophistication and precedent, have driven a major increase in out-of-court "liability management" transactions (LMTs). Commentators counted 21 liability management transactions in 2023, more than double the previous peak of ten in 2020, and 2024 has shown continued acceleration in the space, with analysts observing at least 29 LMTs in H1 2024 alone. Debt investors not previously known for aggressive tactics have proved willing and eager to participate in priming transactions (perhaps out of fear of being primed themselves), while sponsors who had previously stayed on the sidelines, facing challenges at their portfolio companies, took the plunge.

Liability management technology also continues to evolve, with "double dip" and "pari plus" transactions emerging last year, offering new pathways for borrowers to parlay their existing debt baskets for additional credit support in return for correspondingly cheaper debt.

In picking the best liability management path for a distressed portfolio company, sponsors should carefully consider not just the upfront transaction analysis, but the likelihood (and cost) of any litigation that follows a disputed transaction. It is critical to be fluent in the evolving case law

(for instance, two recent cases in just the last two months, Incora and Robertshaw, will have a heavy impact on transaction structures that involve the issuance of new "add on" debt in order to achieve requisite voting percentages). Some sponsors, weighing these considerations, have concluded that, when available, they would prefer to do "tiered" liability management transactions than "winner take all" transactions. In tiered deals, a lead creditor group receives greater compensation than the rest of the participants, but minority creditors receive an opportunity for a consolation exchange on lesser, though still meaningful, terms – when possible, such structures can provide sponsors with most of the benefits of a liability management transaction, while avoiding detrimental litigation.

In any case, no field of corporate law is evolving faster than liability management. Yesterday's transaction structure may not be right for today's deal, and sponsors and their advisors must be flexible and thoughtful.

Funds and Fundraising

Fundraising faces headwinds... while dry powder accumulates

Private equity sponsors have faced a relatively lean fundraising environment since the highs of early 2022, as many institutional investors have slowed their investment pace and shifted their focus toward other asset classes. In a reflection of the weaker fundraising environment, equity contributions from asset managers into new funds increased to an average of 5% from 2% last year, as limited partners putting money in have demanded more "skin in the game" from sponsors – in addition to fee discounts, co-investment rights and the release of capital tied up in previous funds. Yet even as fundraising has remained tight, uncommitted capital has continued to accumulate amid a relative dearth of deals.

While the fundraising environment remains challenging, some bright spots exist. Sovereign wealth funds have played increasingly bigger roles across fund types. And alternative asset managers continue to push into the retail market, with Apollo, Blackstone and KKR, among others, showing billions of inflows in recent quarters from high-net-worth individuals seeking higher-returning investments across investment classes.

Fund-level financing considerations

The elevated interest rate environment has driven NAV loans and margin borrowing to newfound prominence. The NAV financing market, approximately USD100 billion at present, is projected by some commentators to triple in size by 2025. These loans have drawn some handwringing from commentators concerned about layers of leverage. However, NAV facilities have appropriate roles in the fund-financing toolkit, for instance by providing capital for follow-on acquisitions at existing portfolio companies while leaving cheap company-level debt structures untouched, and will continue to be a smart and useful tool in the hands of sponsors with mature portfolios.

Regulatory Developments

Antitrust regulators up the ante

Private equity has been a key focus for the US antitrust agencies for several years now, and recent developments suggest that increased scrutiny of the industry will continue. Following calls in recent years from the Department of Justice (DOJ) and the Federal Trade Commission (FTC) for increased antitrust enforcement targeting private equity roll-up strategies, in September 2023 the FTC filed its first lawsuit based on

a "serial acquirer" theory against private equity investor Welsh, Carson, Anderson & Stowe. The FTC's complaint alleged that, beginning in 2012, Welsh Carson directed a "roll-up scheme" to monopolise and reduce competition for anesthesia services in Texas through the acquisition of over a dozen anesthesia practices. The complaint sought unspecified "structural relief" that could include unwinding prior consummated deals, which mostly were small enough not to require filings under the HSR Act.

Although a Texas court recently dismissed Welsh Carson from the FTC's "serial acquirer" case in May 2024, the FTC and DOJ appear undeterred by the set-back. The same month, the agencies announced a joint public inquiry and request for information into roll-ups across all sectors and industries in the US economy. By soliciting comments directly from customers and other market participants, the agencies hope to learn about transactions that fall below reporting guidelines but may nonetheless raise antitrust concerns.

In further support of this strategy, last year the agencies embarked on an effort to equip themselves with better tools to detect and challenge "roll-up" strategies through formal and informal rulemaking. The agencies announced proposed revisions of the HSR Act notification form that would require notifying parties to disclose acquisitions in the same industry in the ten years prior to the notification, and new Merger Guidelines include a new theory of harm based on "serial acquisitions" and make clear that the competitive effects of private equity roll-ups cannot escape scrutiny "even if no single acquisition on its own" is anticompetitive. Instead, where a transaction is part of a series, the agencies will consider whether the cumulative effect of the trend or strategy of serial acquisitions may result in a violation of the antitrust laws.

* * *

The second half of 2024 holds the potential to reverse more than two years of deal-volume declines, especially if interest rate cuts materialise and valuation expectations are recalibrated. But, as the last several years have shown, the only market feature that is predictable is an element of surprise, particularly in an election year. As in the past, it is expected that sponsors will continue to find innovative wedges to drive new dealmaking and adapt as market conditions inevitably continue to evolve.

USA – TEXAS

Trends and Developments

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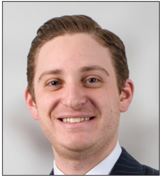

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Financial Investors: Bridging the Valuation Gap and Liquidity

Introduction

Persistent global financial headwinds and geopolitical events of the past few years, among other factors, have provided challenging market conditions for financial sponsors looking to deploy dry powder for new investment platforms and/or obtain liquidity for their aging portfolios.

As widely reported, higher interest rates and inflationary forces have resulted in debt financings becoming increasingly expensive, and sellers continue to find it difficult to maintain the valuations of their businesses that the market had seen between 2020-22. This has led to the widening of valuation gaps between buyers and sellers.

The gap in price expectations between buyers and sellers has also made it difficult for financial sponsors to provide liquidity to its limited partners. In fact, we are seeing an increase in the duration of financial sponsors' holding periods of assets, as they look to delay exits until the valuations of their assets recover or for portfolio company revenues and EBITDA to increase to compensate for the current low multiple environment.

In light of growing valuation gaps and delayed exits, financial sponsors are digging deep into their playbook of alternative deal consideration structures to execute transactions and are hyper-sensitive to ensure they have the control and flexibility to obtain liquidity.

Bridging the valuation gap

Deferred consideration

Given the day light on bid and ask valuations for target businesses, acquiring financial sponsors are increasingly looking to defer the payment of deal consideration over time, so that the business case of the target, as presented by the sellers, can be adequately tested in the years immediately following closing. Deferred consideration mechanics enables the acquiring sponsor to, among other potential benefits and depending on the elected structure:

- pay a more accurate valuation for a target business;
- lower the amount of capital a buyer has to deploy at closing;
- pay the deferred consideration through profits of the target business; and
- take additional time to find financing sources that may result in a lower cost capital than if the full purchase price was paid at closing.

Deferred payments are typically structured as earn-outs that are tied to an agreed financial metric of the target business (eg, EBITDA or revenues) and have successive earn-out periods, with each respective period routinely spanning for one year, ranging in the aggregate between two and five years post-closing of the transaction. Sellers will typically look to negotiate earn-out amounts being payable on a sliding scale, in lieu of a payment of the full earn-out amount upon a financial threshold of the target being met or exceeded, and if yearly results fall between the threshold and target figure, a corresponding percentage of the earn-out amount will become payable from the buyer to the seller. Some sellers may even look to obtain a catch-up payment to the extent the agreed financial targets in prior years are not met, but are then exceeded in later earn-out periods. Further, when negotiating the conduct provisions in respect of an earn-out, financial sponsors will seek to:

- limit or restrict the seller's ability to affect the financial sponsor's control of the operations of the target business; and
- accelerate earn-out payments upon a direct or indirect change of control of the target business.

Alternatively, deferred consideration can take the form of instalment payments which, unlike earn-outs, are not contingent on the financial performance of the target business – therefore this form of deal consideration payments are preferred by sellers over earn-outs. Instalment payments are routinely paid annually after the fiscal year-end of the target business, but may also be set at difference cadences, such as monthly or quarterly payments. The instalment payment amounts can also be fixed or can be scaled up or down over the life of the payment schedule.

Rollovers

Another way financial sponsors look to bridge the valuation gap on the buy-side is by offering deal consideration that is a mix of cash and equity interests of the go-forward business. Often financial sponsors may require founders and executive management members who are selling the target business, to continue to hold a share of the target business post-completion. This can be structured in several different ways, but typically in the US, founders and executive management members will roll a portion of their equity interests into the target business post-completion.

Founders, and those members of the management participating in the equity structure, find rollover equity attractive because:

- they not only receive partial liquidity at closing, but are also able to participate in the growth of the target's business post-closing; and
- they are able to defer taxes on the portion of their equity stakes rolled into the post-closing equity structure.

Similarly, rollovers are attractive to financial sponsors for several reasons, such as limiting the amount of equity capital needed by financial sponsors to fund the purchase price, avoid or diminish the amount of debt financing needed to fund the acquisition (which is currently expensive) and, most importantly, keeping the founders and those members of management who participate in the equity structure of the target business fully invested in the future growth and success of the target's business post-closing.

Recently, rollovers have evolved to be a more dynamic valuation-bridge mechanic. Similar to earn-outs, in some cases financial sponsors are making all or certain portions of the rollover amount of a purchase price contingent on the post-closing performance of the target business. In particular, rollovers can be set to a one-way or two-way ratchet. A one way rollover ratchet entails the valuation gap amount (ie, the difference in target valuation between the buyer and the seller) being payable by the buyer to the seller on closing, but with such gap amount being forfeited back to the buyer if certain financial metrics are not met by the target business over a specified period of time. A two-way ratchet includes the features of a one way ratchet, but also offers sellers the ability to increase their rollover if the pertinent financial metrics are met and outperformed.

Rollover ratchets have similar considerations for the parties to work through as the other deferred consideration mechanics in a financial sponsor's tool chest, but unlike deferred consideration

routes, rollover ratchets can give both the buyer and seller more comfort that the valuation gap will be bridged, while also directly incentivising rollover sellers to drive the growth of the target business post-closing.

As with all alternative consideration structures, financial sponsors and sellers should seek structuring and tax advice if a rollover ratchet is to be utilised to ensure suitable structuring is in place and appropriate tax treatment is achieved.

Liquidity

Transfers to Continuation Vehicles

Over recent years we have seen an increased number of financial sponsors using continuation funds as a tool to provide liquidity to limited partners in their aging funds, while also enabling financial sponsors to retain beyond the aging fund's term an asset that has not yet achieved its full upside. The financial sponsor sells such asset to the newly formed fund, and limited partners that invested in the legacy fund can either roll all or a portion of their interests into the continuation fund or obtain a full liquidity event. New limited partners may also have the option of participating in the continuation fund.

In order for financial sponsors to have the ability to freely transfer its equity interests in an asset to a continuation fund, it must carefully negotiate the terms of the governance documentation it entered into when the initial platform investment was made. One highly negotiated point in the governance documentation is the financial sponsor's ability to make certain transfers or sell the asset to a third party without the consent of the minority investors (eg, a target business's founders and / or management team) and also have the ability to drag such minority investor into such sale. Given the rise in the use of continuation funds, financial sponsors are seeking to explicitly carve-out such transactions from the tag-along rights of founders, members of the management team in the equity structure of a target business, and other minority investors. This reduces the amount of financing the financial sponsor will need to obtain in order to consummate a transfer of the asset to a continuation fund – which is increasingly important given the current fundraising challenges for financial sponsors and expensive debt markets.

Depending on the capital structure of a target business (eg, co-investment or management incentive schemes), a financial sponsor should pay careful attention to key definitions such as "change of control", "sale", "liquidity event" and similar defined terms, to ensure that a sale to a continuation fund would not trigger vesting or a liquidity event for management. If carve-outs are negotiated, the financial sponsor will have more flexibility as to how to treat outstanding incentive equity in the transaction.

Sale of minority stakes

Financial sponsors are also gaining access to liquidity by selling minority stakes in certain control investments that they would otherwise have sold out entirely in a more buoyant market – such secondary transactions may also be coupled with a smaller equity capital raise to provide fresh capital to the business for continued growth which is attractive for the new minority investor and the existing ones.

Even more important than the consideration financial sponsors should give to the governance documentation of an asset in respect of a transfer of such asset to a continuation fund, financial sponsors should be prepared for a tough negotiation as to governance with the new investor (depending on such new investor's leverage). In some instances, a financial sponsor may capitu-

late on certain important governance terms in order to obtain a higher valuation for its equity interests from the new investor (eg, increased board seats, material veto rights, preferential ranking and clear exit and drag threshold rights).

NAV loans

In seeking liquidity for their limited partners, financial sponsors are using debt to return capital – often taking out net asset value (NAV) loans. Financial sponsors may use debt financing in lieu of an equity financing (eg, sale of minority stakes) to avoid diluting a fund's equity interests in its portfolio of assets.

NAV loans are a type of debt financing that allow financial sponsors to borrow money secured by all of the assets owned by a fund. NAV loans are often extended by banks, insurance companies, and private lenders and while these have been traditionally more common in Europe, they are becoming an increasingly popular alternative liquidity option for sponsors in the US in light of current market conditions. Financial sponsors are turning to NAV loans because debt financing of a single asset is more expensive and capital call lines, which are collateralised by uncalled capital commitments, are unavailable due to the aging life of the fund. In addition to providing liquidity to a financial sponsor's limited partners, NAV loans provide financial sponsors the ability to support portfolio companies (through, among other things, ensuring payment of related management fees), while strategically delaying exits until the valuations of their assets recover or for portfolio company revenues and EBITDA to increase. NAV loans also give financial sponsors the flexibility of considering investment into new assets or roll-up transactions for its platform investments at later stages of a fund's life.

If a financial sponsor is contemplating securing a NAV loan, it is advisable to carefully consider the limited partnership agreement of the fund. Fund organisational documents often restrict securing financing at the fund-level based on the net asset value of its underlying assets. If any such restrictions exist under the organisational documents of the fund, these should be amended to remove any such restrictions prior to securing NAV financing.

Dragged or tagging shareholders

When financial sponsors acquire a target business and negotiate governance arrangements with minority investors (eg, rolling founders or members of management), the representations and warranties (R&Ws), indemnities and restrictive covenants to be provided by dragged-sellers and tagging-sellers, may affect the drag-sale or other transfer process and / or the valuation on such equity interests.

Dragged-sellers and tagging-sellers will seek to:

- limit R&Ws given by them to only fundamental R&Ws (eg, organisation and authority, title to shares);
- not provide certain covenants to the potential buyer, including but not limited to non-solicit, no-contact and non-compete covenants; and
- only be severally liable for breaches of R&Ws.

Conversely, financial sponsors are keen to require dragged-sellers and tagging-sellers to give the same R&Ws, covenants and indemnities as the financial sponsor, including R&Ws regarding the company and its business, because a sale involving multiple investors in the capital structure is less attractive to a potential buyer when seller liability is several, rather than joint and several, due to the fact that the purchaser may have to pursue claims against multiple sell-

ers to satisfy an indemnification claim in full. The more neutral approach is for dragged-sellers and tagging-sellers to make R&Ws for both itself, the company and its business, with the indemnification several for each investor and indemnity capped at the proceeds received by such investor in the sale or transfer. It is worth noting that some practitioners argue that a tagging-seller should be subject to the construct more favourable to the proposed seller in such tag-sale because the tagging-seller is electively participating, whereas dragged-sellers are forced into a drag-sale.

Notably, dragged-sellers may also seek to negotiate that they cannot be dragged into a drag-sale unless the deal consideration is in the form of cash or cash equivalents or in the same form as that being received by the dragging seller. Financial sponsors push back on this as they want to retain flexibility in deal structuring and economics to seek an efficient exit.

ROFO over ROFR

The transfer provisions in the governance documentation of an asset owned by a financial sponsor are critical to understanding the path to liquidity. In particular, the transfer provisions where there are multiple financial sponsors in a structure often contain a requirement that a transferor first satisfy either a right of first offer (ROFO) or right of first refusal (ROFR) of the other investors prior to consummating a transfer of equity interests to a third party. A ROFO is a contractual right of first offer, typically found in the governance documentation of the target portfolio company, pursuant to which an investor must first offer its shares for sale to the other existing investors before it can offer its shares to any third party purchaser (and it must beat the price if it declines an offer from an existing investor and opts to sell to a third party). On the flip side, a ROFR is a contractual right of first refusal, whereby an investor can engage with third parties and look to agree a sale of its shares in the company, but before closing on such sale it must first extend the other existing company investors the right to match the offer of the sale.

In instances where financial sponsors are invested alongside a number of other equity holders and its ownership percentage is 50% or less, financial sponsors prefer including a ROFO in the governance documentation since they are less restrictive than a ROFR; making access to liquidity more feasible. ROFOs are less restrictive than ROFRs because the financial sponsor does not have to first negotiate a deal with a third party purchaser – who may be reluctant to incur fees and expenses in the knowledge that there is the impediment of a ROFR lingering in the background – prior to offering the equity interests to (or receiving offers from) the other equity holders.

Conversely, to the extent minority shareholders have third party transfer rights (ie, that are not conditioned on the consent of the majority shareholder/financial sponsor), then financial sponsors often include a ROFR in the governance documentation for its control transactions which provides the financial sponsor with the ability to manage the equity holders in the capital structure. The ROFR is routinely solely for the benefit of the financial sponsor; it is not reciprocal for other equity holders because of the resistance by financial sponsors to be subject to provisions that restrict the timing and terms of its exit from the investment – in other words, access to liquidity. Nevertheless, there may be instances where a minority equity holder has substantial leverage and may receive a ROFR over transfers by a financial sponsor. In such instances, financial sponsors can avoid the encumbrance

of a ROFR and achieve liquidity by including a carve-out to such ROFR for a drag-sale.

Conclusion

With instability and uncertainty in market conditions expected to persist in the near term, financial sponsors will continue to grapple with the complexity of securing liquidity for their limited partners while also deploying new capital at reasonable valuations. If history is a lens to the future, financial sponsors will continue to find creative solutions to navigate through the constraints.

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