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Challenges accepted

Lead contributors Shaun Lascelles and Steven Daniels from Skadden Arps Slate Meagher & Flom consider the major issues affecting the global private equity market

The financial crisis and its aftermath arguably have presented (and in many respects continue to present) the global private equity (PE) industry with the greatest set of challenges it has faced during its history. In recent years, some commentators have suggested that these challenges might cause a significant shake-out in the PE industry or possibly even lead to its partial demise. However, contrary to these predictions, the industry appears to be gradually emerging from this prolonged period of unprecedented market unrest and economic instability.

Despite the uncertainty of recent periods, the industry appears to be reasonably intact and fundamentally unchanged in terms of its primary objectives. Moreover, in recent months, the private equity industry has enjoyed robust levels of activity in many key markets and sectors, with funds raising record levels of capital from investors.

Record levels of capital available for investment and a historically low interest rate environment should promote US PE activity in the short term as sponsors deploy vast amounts of capital for acquisition-related investment and PE portfolio exits continue to build momentum.

Unsurprisingly, the US PE market remains highly competitive. While increased capital levels have resulted in greater competition for assets, funds have exercised increased discipline in terms of target quality and purchase price multiples. Many sponsors have focused on improving their portfolio companies through smaller add-on acquisitions, while others have taken advantage of the availability of various debt financing alternatives, including high-yield bonds, asset-based finance and non-bank debt, on more borrower-friendly terms, a range of viable exit routes (particularly IPOs on European stock exchanges), an improved, albeit bifurcated, fundraising environment and a very robust secondary market.

Many sponsors operating in Europe, particularly larger alternative asset managers, have reaped the benefits of improving macro-economic conditions and current market trends such as the availability of various debt financing alternatives, including high-yield bonds, asset-based finance and non-bank debt, on more borrower-friendly terms, a range of viable exit routes (particularly IPOs on European stock exchanges), an improved, albeit bifurcated, fundraising environment and a very robust secondary market.

These favourable market conditions have assisted sponsors by significantly improving their European deal flow which, in turn, has enabled them to raise record levels of what is known as dry powder that’s now ready for future deployment. In recent months, European PE activity has taken a variety of forms, including leveraged buyouts, refinancings, follow-on sales, trade sales, secondary buyouts, bolt-on deals and secondary transactions, with sponsor-backed flotations on European stock exchanges particularly prevalent.

The US remains a key jurisdiction for PE activity among both domestic and international investors. Having maintained relative economic stability in the wake of the global economic crisis, the US has benefited from a perception of safety among investors in the global market. As a result, investment in US PE funds and the total value of PE investment in US targets both increased in 2013.

European deal flow which, in turn, has enabled them to raise record levels of what is known as dry powder that’s now ready for future deployment. In recent months, European PE activity has taken a variety of forms, including leveraged buyouts, refinancings, follow-on sales, trade sales, secondary buyouts, bolt-on deals and secondary transactions, with sponsor-backed flotations on European stock exchanges particularly prevalent.

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If sponsors operating in Europe continue to exercise discipline as the industry recovers, while remaining ready to adapt to changing economic or market conditions, the prospects for a sustainable revival are strong.

Asia-Pacific
In common with other emerging markets, the Asia-Pacific region experienced a slowdown in M&A activity following the financial downturn, a trend exacerbated by the strong focus of large Chinese and Japanese corporates and financial sponsors on outbound investments in the US and Europe. Lately, however, PE has become an increasingly important feature of the Asia-Pacific region’s M&A landscape.

Successful fundraisings by Asia-Pacific-focused PE funds have led to a gradual increase in the levels of capital available for investment in the region. As a consequence, both global and regional sponsors have become increasingly active in the region, particularly in China, Japan and Hong Kong.

In certain key countries in the region, the low-hanging fruit is quickly disappearing and difficulties remain in conducting due diligence, obtaining financing and regulatory approvals and achieving successful exits. In the short-term, the already challenging investment environments in these countries are likely to become more competitive, as investors vie for the relatively scarce number of well-managed businesses likely to deliver sustainable growth. However, as these countries begin to rebalance their economies and introduce important legal and regulatory reforms and the Asia-Pacific PE industry continues to mature, the medium to long-term prospects for PE investment in the region look promising.

Latin and Central America
In recent years, factors such as slower economic growth, political uncertainty, differing price expectations and the levying of taxes on foreign capital have dampened the appetite of sponsors to invest in Brazil. However, sponsors remain reasonably upbeat about Brazil’s medium to long-term prospects given its large population, burgeoning middle class and relatively investor-friendly regime and the recent announcement of major regulatory reforms and a multi-billion dollar infrastructure modernisation programme.

As Brazil fell out of favour, other Latin and Central American countries such as Mexico, Colombia, Peru and Chile, whose economies are expected to outpace the average global economic growth rate in the coming years, witnessed considerable interest from regional and international sponsors. If these countries can continue to implement policies designed to improve their key industries, promote cross-border trade and foreign direct investment and facilitate tax-efficient acquisitions and disposals, their popularity among sponsors and their limited partners should remain strong.

Many sponsors have focused on improving their portfolio companies through smaller add-on acquisitions

In the race to attract regional and international PE investment, those Latin and Central American countries with strong demographics, considerable infrastructure and energy deficits and governments keen to promote economic stability, sustainable growth and inward investment should outperform their neighbours.

Rising to the challenges
While the global PE industry is undoubtedly in a much-improved state, the recovery remains delicate and the industry continues to face a significant number of formidable challenges. These range from political, economic and regulatory challenges including political risk and increased regulatory burdens on sponsors to market-driven challenges such as intensifying competition in the fundraising market.

Those sponsors who apply the hard lessons learned from the financial crisis, avoid the excesses of the recent past and adapt to the dynamic investment landscape stand the best chance of rising to these challenges and reaping the benefits of what will hopefully be a sustained recovery for the global PE industry as a whole.

About the author
Shaun Lascelles is a partner based in Skadden’s London office, where his practice concentrates on cross-border mergers and acquisitions, joint ventures and private equity transactions. He is co-head of Skadden’s global private equity group.

About the author
Steven Daniels is a partner in Skadden’s Wilmington office. He has a broad-ranging corporate practice focused primarily on M&A, private equity transactions and securities law matters, as well as providing advice on issues of Delaware law, including fiduciary duty and corporate governance matters.
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The return of private equity following the financial crisis has been accompanied by regulatory hurdles, new financial burdens and increasing public scrutiny. Growing misconceptions about private equity investment have affected its image and attracted the attention of regulators. Jason Mulvihill, general counsel for the Private Equity Growth Capital Council (PEGCC) discusses how the industry is adapting to these challenges and what is next on the horizon.

What are the biggest regulatory hurdles facing private equity now?
Private equity (PE) has been hit with a tidal wave of new regulations over the past several years, both in the US and internationally. This includes registration with the Securities and Exchange Commission (SEC) for most US private equity investment advisors and the implementation of the European Alternative Investment Fund Managers Directive (AIFMD). Firms are adapting to this new regulatory environment and the associated costs that go along with it. Unfortunately, many regulators still lack a sophisticated understanding of PE and often conflate PE funds with hedge funds and other types of financial services firms. When this happens, pressure builds to impose even more restrictions on PE that do not make sense.

The tax treatment of carried interest has been receiving a lot of attention recently. How do you expect this to affect fund structures?
The PEGCC (Private Equity Growth Capital Council) believes that carried interest (the general partner’s share of partnership profits) is appropriately taxed as capital gains income in the US. We are working to ensure that public policy continues to incentivise long-term investment and the entrepreneurial risk-taking required to start, save, and grow businesses. With that said, the tax treatment of carried interest remains a topic of discussion for many policy-makers on both sides of the Atlantic. This does not mean that any changes to the taxation of carried interest will occur in the near future or beyond, and contrary to some of the media speculation on the topic, change is not inevitable. Accordingly, it is difficult to prognosticate about potential fund structure alterations when a change in long-standing tax law is far from certain.

How do you expect the Volcker Rule will impact capital raising? Will it direct more firms to other jurisdictions?
The Volcker Rule will limit the ability of US banking entities to invest their own capital in PE. While this is not ideal for the banks or the PE industry, I do not believe that fundraising by PE firms not affiliated with banking entities will be materially damaged. It is important to recognise that the final Volcker Rule regulations permit many investments in PE to continue. For example, insurance company general accounts and separate accounts are not subject to the restrictions on investing in PE. The same is true when a banking entity invests in private funds while acting in a fiduciary or similar capacity on behalf of its customers (as opposed to investing the bank’s own money).

Challenges ahead

Jason Mulvihill, general counsel of the Private Equity Growth Capital Council, discusses how misconceptions about private equity are raising new challenges for the industry.

The US government, as a matter of policy, should encourage more investment in US PE and not limit it any further.
Regulators should ensure they do not use the vaguely defined shadow banking concept as an excuse to impose new regulations on activities that are not shadow banking

Bank pension plans and bank employees in their individual capacities may also continue to invest in PE. The final Volcker Rule also preserves the ability of foreign banking entities to invest in PE via parallel fund structures sponsored by US PE firms. PE is the best performing alternative asset class over the long-term. The US government, as a matter of policy, should encourage more investment in US PE and not limit it any further.

How do you view the role of private equity in shadow banking? Do you expect this to remain?

Recent attention on so-called shadow banking has led some to erroneously lump PE into this category of business. This assertion could not be further from the truth. PE funds are not shadow banks and they do not present systemic risk.

Since the financial crisis, regulators have sought to identify shadow-bank ing activities, and have been asking two questions: does an entity that is not a regulated bank engage in certain activities, such as lending; and, if so, could the distress or failure of that entity cause ripple effects through the financial system and broader economy? When these questions are applied to buyout, growth capital and venture capital funds, it is clear that these funds do not engage in traditional banking activities and do not present systemic risk.

Some suggest, though, that PE-style (closed-end) mezzanine debt funds, distressed debt funds and credit funds do engage in some traditional banking activity. In fact, the activities of those funds are very different from traditional banking activity. But even if you accept the earlier argument, those funds are not shadow banks and they do not present systemic risk.

How have fund governance structures changed over the last five years? What are the main drivers and what will need to adapt in the future?

Over the last two decades, limited partners—individually and working together through organisations like the Institutional Limited Partners Association (ILPA)—have negotiated for and obtained numerous governance rights and protections in fund partnership agreements and side letters. Governance provisions include key man provisions, no fault suspension and removal provisions, for cause removal and dissolution rights and increased Advisory Committee oversight. Looking to the future, fund governance structures will need to continue to provide appropriate limited partner oversight while still giving general partners the ability to perform the necessary tasks they are hired to perform; share appropriate information with limited partners and regulators; and enable funds to continue producing outsized returns for limited partners.

How important to the business of private equity has market-based financing become and what might be the effect of regulation in this area?

Some PE funds may turn to market-based financing options when acquiring portfolio companies, particularly if banks are unavailable to provide appropriate funding for a transaction. PE portfolio companies, like any other operational businesses, will likely continue to consider market-based financing options when needed in the future.

As regulators around the world continue to assess whether more regulation of shadow banking would be appropriate and necessary, regulators should make sure that they do not use the vaguely defined shadow banking concept as an excuse to impose a series of new regulations and burdens on a whole series of activities—including buyout, growth capital and venture capital funds—that are not shadow banking. Discretion is the better part of valour.

Have enough steps been taken to create transparency in the market? Have any of the moves been detrimental to PE firm’s competitive advantage?

Private equity firm and funds have a history of transparency with their limited partners. This transparency is mandated by the limited partnership agreements that general partners and limited partners negotiate in advance of limited partners investing in a private equity fund. This is nothing new although limited partners have demanded much more extensive and customised reporting over the past several years than was previously the case. More recently, transparency has also been increased for regulators. Appropriate transparency is a good thing, but it must be balanced in a way that ensures that private equity firms and funds are still able to pursue their own strategies for growing and strengthening the companies in which they invest.

About the contributor

Jason Mulvihill serves as general counsel for the Private Equity Growth Capital Council (PEGCC). As general counsel, Mulvihill has primary responsibility for regulatory matters, and he also oversees the PEGCC’s General Counsels’ Committee and the Chief Compliance Officers’ Working Group. He also plays an active leadership role on legislative private equity issues.

Before joining the PEGCC, Mulvihill served as legislative director and chief counsel for Senator John Ensign (R-NV). In this capacity, Mulvihill developed and led strategic initiatives that supported the Senator’s pro-business policy goals, managed his legislative staff, and was also responsible for tax and trade issues before the Senate Finance Committee. Before working on Capitol Hill, Mulvihill was an associate at Skadden Arps Slate Meagher & Flom in Washington, DC, practicing antitrust law.
Success in Asian private equity is not easy to achieve. Volatile economies and regulatory hurdles have created barriers for firms, but an additional problem is a dearth of deals – especially control deals. This is because entrepreneurs are not yet willing to relinquish control of their businesses. Exits can be equally challenging, especially when considering that the China IPO market was closed for much of 2013.

But there are bright spots: Baring Private Equity Asia (BPEA), in particular, has been a part of many highlight deals. This year it exited for-profit education provider Nord Anglia Education through a $304 million US IPO. Before that, the company closed two innovative high-yield deals – including a rare Asian payment-in-kind (PIK) note in 2013. Going against market sentiment, last year it also completed two India deals – one for a majority stake in India-listed company Hexaware and the other for a minority stake in French cement-maker Lafarge’s India unit.

Baring also took a leading role in the club deal to take US-listed Chinese online game company Giant Interactive private, and was one of four investors to recently announce a strategic investment in Chinese pork company Cofco Meat. Its portfolio company Kangda International Environmental Company Limited debuted July 4 on the Hong Kong Stock Exchange.

IFLR spoke with William Hay, BPEA’s general counsel, about developments in Asian private equity, as well as domestic and extraterritorial regulations that affect private equity in the region.

What is BPEA’s investment strategy? What are the primary sectors and sizes of its investments?

We have two primary investment strategies. Our first and oldest investment strategy is growth equity, in which we take minority stakes in companies that have passed the startup stage, have a strong position in the markets they serve and have reached positive income or earnings before interest, taxes, depreciation and amortisation (Ebitda) performance. They generally have the potential for an IPO between one to five years after the investment.

We invest as a partner to the entrepreneur who started the company. Although we provide capital, more importantly, we have the operational capability to help the company create additional value through accelerating its growth and organisational competence. More than half of our transactions across Asia are that type of investment.

The raw number of targets in the control space is much lower than it is in the West.
In the buyout space, there are fewer deals but the deal size is much larger. If necessary, we’ll club up with other private equity funds to take control of a company. For example, in US-listed Giant Interactive’s take-private, we’re working with a number of other private equity funds.

On sectors, we’re fairly agnostic. In recent years, we’ve been attracted to the consumer story, which is driven by the rise of the middle class in Asia. As individuals have more money, they tend to deploy it on themselves – from women’s cosmetic masks to private education. And more money to spend creates new industries around the region.

We’re thrilled about what may happen in India

In terms of size, we usually look for deals where our investment is in the $75 million to $300 million range, going all the way up to Giant, which is $3 billion in enterprise valuation.

It seems that most PE firms are looking at control deals. How do local regulatory regimes limit control in Asia? Are there any especially sensitive sectors?

The raw number of targets in the control space is much lower across Asia than it is in the west. However many family businesses are now reaching a transition stage, where the entrepreneur is in his early 50s or 60s and isn’t sure if his family will take it forward, or is just motivated to sell now.

In China, we can realistically only do control deals with private sector companies. Generally speaking, it’s hard to do a control deal with a state-owned enterprise unless they want to get out of mature lines of business.

On the regulatory side, countries from India to the Philippines and China have industries that they regard as sensitive in which they limit foreign ownership. That limit depends on the sector. And licensing requirements in some industries such as financial services mean that it’s theoretically possible for foreign investors to own assets. But the hurdles make investment unlikely.

Those restrictions may be seen as examples of protectionism, but, in just as many cases, sectors are closed for rational reasons. For example, in China, the market might not be ready to have 300 foreign financial institutions operating freely, because of the potential macroeconomic impact of additional credit supply and on the volatility of the international balance of payments.

Are there any jurisdictions industries that are becoming exciting investment opportunities because of government actions, such as loosened FDI regimes or increased support?

India is becoming much more exciting after the elections. It’s too early to bank on it, but Modi – who was anticipating victory – had assembled a team of technocrats before he started his tenure as Prime Minister with an action plan to carry out after the election. That’s likely to remove some of the regulations and loosen some of the political and regulatory fetters that have bound the economy. We’re thrilled about what may happen in India.

In China, Xi Jinping has pushed hard to reform the state structure and weaken the government off infrastructure projects, as well as to move the economy’s focus towards the consumer side. Those initiatives may play a powerful role in expanding the role of private equity and foreign capital.

How have exit strategies evolved over the last five years? Should we expect to see more exits via IPOs or secondary sales?

Exit via IPO is the more common goal for PE firms. That goes back to venture capital in the US in the 1970s, when the model of the business was to find companies that could be exited through high-value IPOs in a few years. Liquidity in the IPO market tends to stimulate deal activity and support valuation in earlier stage companies, thus drawing more PE money into a greater number of targets.

Strategic sales come to the fore when the IPO market is slow. If the IPO market is locked up, there are more strategic sales or on-sales to other funds. Since the IPO market has been relatively liquid recently, we’re planning several exits of China-sourced deals in the Hong Kong IPO market.

BPEA portfolio company and private school operator Nord Anglia listed in the US this year. Given the competition between the Hong Kong and US IPO markets, is the US also an option?

Nord Anglia may have been an exception. It’s an education-focused company, and the analysts who follow for-profit education are concentrated in the US. Their knowledge of the sector helped support a higher valuation.

But a US-listed company like Giant Interactive has a slightly different valuation and model than US gaming companies. When the time comes, we’ll certainly have to take a closer look at the Asian exchanges because there may be a home advantage.

How have extraterritorial regulations from the US, EU and the UK affected private equity in Asia?

The EU’s Alternative Investment Fund Managers Directive (AIFMD) has had the biggest impact. It has been a concern for us because it affects our ability to call on the institutions that have been with us from 10 to 15 years. We have to rely on them coming to us to ask if we’re in the market for a fund because the requirements to freely offer include a lot of registration and bureaucracy. That’s a major burden for funds without a presence in the EU.

Although the US is increasing its scrutiny of funds like us, that’s been informational – not regulatory – so far. That’s an issue we’re keeping an eye on.

The search for yield in the US and Europe means that it’s springtime for leveraged finance in Asia

The other extraterritorial regulations are issues around anti-bribery and compliance and that’s about good hygiene. Our investors certainly expect full compliance here. It’s been a focus for us, but it’s also been a largely positive development.

How has Asian acquisition financing evolved in the last year? Do you expect to see more leveraged buyouts and possibly more mezzanine debt in the future?

It’s been a brilliant year for the evolution of acquisition finance in Asia. We did two bonds on Nord Anglia: they’re the same kind of product, and both helped refinance our existing investment. The market saw the success of these deals, which helped energise the market.
The search for yield in the US and Europe means that it’s springtime for leveraged finance in Asia. You can see it in the bank market: we didn’t have any trouble placing the debt we needed for the Giant transaction. We’re now looking at financing new deals with the same type of bond structure that we used for Nord Anglia, only in the acquisition context.

The machinery in the US was set up to do this for US companies and US investors, so the documents are all US law documents. We’re talking with people about working on this in future transactions. I expect the senior debt side to move forward dramatically.

We’re also seeing more interest in mezzanine debt than we ever have before. The mezzanine market is more global, and has smaller tickets. The Hong Kong branches of international banks and some of the Chinese banks are coming to us with mezzanine products that may be syndicated to high net worth individuals. For example, if you’re considering a $500 million senior debt facility, $50 to $75 million of that may be in a mezzanine tranche. A bank with a good HWNI client base could place that easily.

About the contributor
William Hay is general counsel of Baring Private Equity Asia, a leading Asia-based private equity firm with $5 billion under management. Prior to joining Baring, he held similar positions with GE Capital Asia and Colony Capital. Hay was also a partner in a Wall Street law firm before relocating to Hong Kong in 1995.

Hay’s transactional experience includes private equity, real estate, distressed debt and other acquisitions and investments across greater China, Japan, Korea, India and Southeast Asia. He has structured and managed private equity and real estate funds in Asia, and is an expert in compliance issues in the region.

Hay received his BA from UC Berkeley in 1973, his AM from Harvard’s East Asian regional studies program in 1978 and his JD magna cum laude from Harvard Law School in 1982. He is a qualified lawyer in Hong Kong and New York and is fluent in Mandarin Chinese.
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For the past decade, African markets have been gaining the attention of private equity and venture capital investors. With increasing regulatory improvements and growing exit opportunities, many investments look to be paying off. While the growth in the continent’s economies continues to offer new avenues for investment and expansion, hurdles still remain. Sponsors must consider stability, corporate governance and the impact on local communities. Co-chair of the African Private Equity and Venture Capital Association’s (AVCA) legal and regulatory committee, Mara Topping, addresses these developments and the continent’s outlook going forward.

What do you think has been the most significant development in the private equity space across Africa over the last five years?

One recent development in African private equity (PE) which may prove to be significant for the industry is that of changing regulations governing the investment of pension fund assets of some African countries including Kenya, Namibia, Nigeria, and South Africa. Each of these countries has recently made changes to the asset allocation rules of its state pension fund, allowing for investment – of up to 15% in some cases – of pension assets in private companies. As a result, we are already seeing African investors increasingly investing in African PE. Moreover, as pension fund regulators and administrators become more familiar with the benefits of PE, this will present an opportunity to increase the level of capital available to the private sector in Africa. It is likely that this local support will also build the confidence of international investors to invest further in African private equity.

One of the major challenges for investments into Africa has been ensuring a good exit. What options are now available and what types are still difficult to complete?

There is a common misconception among investors that there are few exit routes for African PE. While the majority of successful exits in the Sub-Saharan Africa region have been strategic sales to operators and company sponsors, plenty of other options exist for exits. These include: international equity markets; African equity markets (historically characterized as lacking depth, although general partners are achieving exits this way, for example the Emerging Capital Partners’ listing of Société d’Articles Hygiéniques on the Tunisian Stock Exchange in December 2013); and structured exits (involving structuring deals to allow for a put, swap or share buyback as a fallback exit option in the event that an exit via an initial public offering (IPO) or strategic or trade sale is not optimal). In effect, creative exit solutions can be in place from day one, built into the investment trajectory and tailored to the investment in question.
How has the broadening of exit routes impacted incoming investment?

AVCA has conducted some interesting annual value creation studies with Ernst & Young that indicate that the African PE industry is maturing fast and moving out of its infancy, which is apparent from a broadening of exit routes. Sales to other PE houses now account for a far greater share of portfolio realisations than previously. While trade sales remain the key exit route — and among the most profitable for PE — the increasing options available to PE for exits should encourage new investors in Africa.

Research by AVCA pointed to the fact that investments in some of the least developed markets are often some of the best performing. How can funds looking into these markets protect their investments?

I would recommend ensuring that they have local, experienced managers with an up-to-date working knowledge of legal and regulatory policies, and good legal counsel that can build in contractual protections to mitigate risk.

How have regulators and government officials reacted to the needs of investors?

In many cases, they have reacted very positively, as they are looking to increase ease of business in their countries (for example, the changes to local pension fund regulations). In other instances, countries have actually invited professional associations such as AVCA and the Emerging Markets Private Equity Association (EMPEA) to work with the regulators to help them create a more favourable environment for PE.

When thinking about what investment vehicles are best for African investments what factors are most important to keep in mind?

Track record, local networks, diversified investments and good, knowledgeable legal counsel!

In addition to traditional fund structures, new fund managers or fund managers with little experience investing in Africa may seek investment through a co-investment structure on a particular investment, or may also raise funds on a deal-by-deal basis. These structures are becoming more common for first-time fund managers, as they reduce the relative risk for investors compared to the traditional fund structure, and can often help build the fund manager’s track record, investment reputation and investor relationships.

There are also interesting evergreen holding company models developing as alternatives to the term-limited closed pool vehicle model, which are more responsive to the longer life cycles in certain sectors such as infrastructure, healthcare, agri-business and education.

It is likely that this local support will also build the confidence of international investors to invest further in African private equity.

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Section 1 – PRIVATE EQUITY LANDSCAPE

1.1 How would you describe the current state of private equity activity in your jurisdiction, including the most common forms of private equity transactions?
The volume of Private Equity (PE) transactions is solid, due to quite sizeable transactions in the first four months, including the acquisition of GEA Heat Exchangers by Triton and of Mauser by Clayton Dubilier & Rice. There appears to be a lack of attractive targets in the small and mid-cap markets.

Low interest rates, banks’ strong appetite to finance transactions and the lack of investment opportunities, have caused prices to remain relatively high. Initial public offerings (IPOs) as exit routes are not as important as trade sales.

1.2 Are there any factors that make your jurisdiction attractive to private equity investment at this time or that will spur private equity investment in the near term?
After the financial crisis, Germany has proven to be an economic stronghold within continental Europe. Many companies, particularly small and medium-sized enterprises (SMEs), are market or technology leaders in their industry.

For years the German Mittelstand (SME) has been expected to provide a wide range of attractive investment opportunities. So far, this has not materialised, but it is only a matter of time. Doing business with the Mittelstand may require flexibility and creativity concerning investment structure and shareholder relations.

The role of PE in Germany is still under-represented in German M&A compared, for example, to the UK market.

Section 2 – SIGNIFICANT LEGAL DEVELOPMENTS

2.1 Have there been any recent regulatory developments, including tax developments, in your jurisdiction affecting the raising, formation, governing terms or operation of private equity investment funds or investments made by funds?
On July 22 2013, the Capital Investment Act (Kapitalanlagegesetzbuch) took effect, which implements the EU Alternative Investment Fund Managers Directive. It protects investors by stipulating uniform regulatory standards, and provides for comprehensive regulation and supervision by the Federal Financial Supervisory Authority (BaFin). The German legislator is discussing a bill, which would provide adjustments to the wording of the regulation; PE sponsors hope that access to capital will be facilitated for so-called semi-professional investors.

2.2 Have anti-corruption legislation and/or environmental, social and governance principles affected the approach of private equity investors and/or transaction terms?
Compliance sensitivity has increased, changing the approach of many investors. Germany is not a high-risk jurisdiction for compliance issues, yet most German targets operate in various countries. If relevant indications exist or targets involve businesses in jurisdictions that are considered to involve increased risks, PE investors tend to address these through a compliance due diligence.

Besides due diligence issues, PE investors will request that sellers grant compliance warranties in transaction documents.

2.3 Could a private equity sponsor (and/or its directors, officers or employees) be exposed to liability for a portfolio company’s actions or omissions in your jurisdiction and if so, on what legal grounds?
PE sponsors aren’t generally held liable for a portfolio company’s actions or omissions. The recent ruling by the EU commission involving a PE sponsor that would be held liable for breaches of antitrust laws by one of its portfolio companies, appears to be confined to antitrust regulations. To date, no legal authority has alleged that these rules should also be applicable to other scenarios.

Liability of a PE fund as shareholder is possible, but only if very specific requirements are satisfied. These include respective actions by the investor, for instance the use of shareholder rights to the detriment of the portfolio company.

Non-executive board members designated by sponsors may be held liable if they breach their fiduciary duties.

Section 3 – FUND FORMATION AND STRUCTURE

3.1 Please describe the typical legal structure used to establish private equity funds, including the primary securities law considerations in private equity fund formation.
PE funds will typically take the form of limited partnerships (Kommanditgesellschaft) as they are tax-efficient and, from a corporate law perspective, flexible vehicles.

Principally, PE investment funds and their managers fall within the scope of the German Capital Investment Act. A fund manager must therefore apply to BaFin to be authorised to manage the fund in Germany. If the fund is marketed in other EU member states the manager should notify BaFin, which will notify the competent non-domestic authorities. This applies mutatis mutandis. If a non-German fund manager with authorisation in another EU member state, wishes to market its fund in Germany, the fund’s supervisory authority will provide BaFin with the relevant permission. Managers that do not qualify as EU alternative investment fund managers may not rely on the passporting mechanism described above.

3.2 How are carried interest arrangements typically structured and is there a prevailing methodology for calculating the sponsor’s carried interest?
Typically, carried interest arrangements are structured through a limited partnership with managers or their vehicles becoming limited partners. That partnership is in turn a special limited partner in the fund limited partnership. Carried interest is usually calculated on a whole-of-fund basis, under which the carried interest entitlement only arises after investors have received a return of their drawn-down capital, plus any preferred return accrued.

3.3 Are fund investors typically subject to claw back or a return of distributions to cover their respective allocations of fund liabilities, such as indemnification payments?
As marketing today is globalised, investors expect essentially the same regulations in German funds as they would find in other jurisdictions. The statements made with respect to the UK generally apply as well.
Section 4 – STRUCTURE OF ACQUISITION VEHICLE

4.1 What type of entity is typically used as the acquisition vehicle for private equity investments in your jurisdiction? What are the key factors that determine the choice of entity?

Most acquisitions are executed through a German limited liability company (GmbH), which is considerably flexible concerning corporate governance. The legal regime governing stock corporations (AG) is much stricter and essentially designed for listed companies. Partnerships are rarely found in acquisition structures, and use of a German partnership may result in adverse tax effects.

4.2 Does the structure of the acquisition vehicle vary depending on the nature of the investors in the private equity purchaser’s fund?

The structure of the acquisition vehicle should be relatively independent from the nature of the investors. In general, the structure above the acquisition vehicle should be influenced by it (see 5.1).

4.3 Describe how the choice of acquisition vehicle affects the nature of the incentive equity compensation that can be offered to management.

The choice of the acquisition vehicle should not affect the nature of the incentive equity compensation. Management normally expects an actual (as opposed to a virtual) participation in the target, in most cases bundled in an entity that will be tax transparent.

Section 5 – ACQUISITION STRUCTURE

5.1 What are the typical structures used by private equity sponsors to acquire portfolio companies in your jurisdiction? What are the major considerations that govern this decision?

Acquisition structures are mainly driven by tax aspects. Typically, PE funds aim to achieve exit proceeds that are subject to a preferred tax rate and a deductibility of interest charged on bank and shareholder financing to the greatest extent possible. Important drivers are often the creation of a fiscal unity between target group companies (allowing for a set-off of losses incurred in one company against profits in another).

Often the acquisition company will be held by a holding company, which may be domiciled outside of Germany (double-tier structure). These structures may avoid the shares held by the PE investor becoming part of the security package granted to financing banks. Management may invest in the acquisition or the holding company depending on tax considerations.

5.2 What are the major issues that drive deal timing in your jurisdiction, including disclosure obligations financing and regulatory approval requirements?

Most transactions are subject to antitrust clearance, and therefore, will envisage a deferred closing. The parties must agree on deal terms that address this.

Sellers expect that by signing, the purchaser is entering into binding financing agreements which are subject only to customary conditions precedent. Agreements on collateral will then normally be negotiated with the banks after signing.

If the target company is listed, the purchaser has to disclose its intent to launch a tender offer. Disclosure is principally not required unless the contemplated transaction is expected to have a material impact on the share price of the seller.

Section 6 – GOVERNANCE

6.1 Are there any legal requirements in your jurisdiction that would prevent or otherwise affect the ability of a private equity acquirer to designate members of the board and/or management of its portfolio companies? Are there any legal risks for the private equity acquirer in designating such members?

No, PE investors usually take a passive investor position, which is not changed through the designation of board members. However, this should not be the basis for exposure of the PE sponsor regarding liabilities of the portfolio company.

6.2 Are veto rights over major corporate actions (such as dissolution and winding up, merger or consolidation, significant acquisitions or dispositions, incurrence of material indebtedness, or changing the business of the company) typical rights held by private equity acquirers? Are there any limitations or prohibitions on such rights?

Veto rights only become relevant if the acquirer does not control the target. PE acquirers typically have veto rights either as a matter of law given their shareholding percentage or on a contractual basis. The rights conferred upon the PE investor are then subject to either contractual rights conceded to the minority or mandatory statutory minority rights, which may not even be waived by the protected party. Such minority rights may stipulate that special majorities are required for certain resolutions or provide for rights to participate in shareholder meetings or to inspect accounts. The scope of statutory minority rights may differ subject to the relevant type of corporate entity involved.

6.3 Do private equity funds or any board members they appoint, have any fiduciary or other duties to minority equity-holders or other stakeholders of a portfolio company? Are there any prohibitions against acquisitions of, or investments in, competing or complimentary businesses?

PE funds as shareholders owe fiduciary duties to the company in which they are invested, and to a limited extent, other shareholders, subject to specific definitions by the courts. Management board members primarily owe a fiduciary duty to the company, not the shareholders. Members of a supervisory board are principally independent and may only act in the best interest of the company; such may be determined differently for members of an advisory board. Said duties will usually encompass prohibitions to operate or invest in competing businesses.

Section 7 – DEAL TERMS

7.1 What pricing structures are typically preferred by private equity sponsors in your jurisdiction?

PE sponsors, particularly as sellers, prefer locked-box purchase prices without any true up at closing or any earn-out. On the acquiring side, locked-box systems have also become widely accepted from purchasers’ perspectives.

7.2 What is the typical scope of the representations and/or warranties, covenants, undertakings and indemnities provided by a private equity seller and the target company’s management team to an acquirer in an acquisition agreement?

PE sponsors typically try to limit warranties to title and capacity. However, subject to the purchase price and the attractiveness of the relevant target, and only if an appropriate cap is agreed or warranties are limited in scope, they may accept warranties regarding financials and the business as well.

Nevertheless, management will often be expected to grant warranties that are broader in scope.

In most transactions, PE sponsors will have to agree on a tax indemnity. Subject to the purchase price and the peculiarities of the target, PE sponsors as sellers may agree on indemnities regarding specific identified, particularly environmental, risks.
Recently, PE funds have been requested for anti-compete covenants. If these are accepted, they should be expected to be clearly confined, for instance to investment in specific companies.

7.3 What are the customary time limits and other limitations on liability applicable to representations and/or warranties given by a private equity seller and the target company’s management team? Warranties regarding business operations would typically be expected to be time-barred after a period of six to 18 months; the statute of limitations for title warranties should range from three to seven years. Indemnities will usually be subject to a different regime; tax indemnities will usually be time-barred after tax assessments have become final and environmental indemnities will often last for five to 10 years. Escrows are rarely provided for more than 18 to 24 months.

7.4 What methods are typically used to fill any ‘warranty gap’ in your jurisdiction? Is warranty and indemnity insurance commonly used in private equity transactions in your jurisdiction? Warranty and indemnity insurances have become more popular in transactions; whether such is taken in by the seller or the buyer will differ from transaction to transaction.

7.5 What conditions to a private equity sponsor’s obligation to complete an acquisition are typically included in the acquisition agreement? Are these conditions usually substantially aligned with the conditions included in the financing documentation? It is not always possible to align conditions precedent in the financing agreement with those provided for in the purchase agreement. In many instances, discussions revolve around the inclusion of a material adverse change provision, which is still frequently contained in financing agreements. Financing-out as a closing condition is very rare. The purchaser may also look for deal-specific closing conditions based on its due diligence.

7.6 To what extent are purchaser funds at risk for the equity capital committed to a transaction? Are third-party beneficiary rights or other enforcement rights typically made available to the seller? Sellers will often request that a PE purchaser issue an equity commitment letter as additional assurance that the purchase price will be paid; these are often specific to the relevant fund. In most cases, the letters are issued for the benefit of the acquisition company and the seller (for payment to the acquisition company).

7.7 How is a management team’s equity participation typically structured, including customary types of equity interest, percentage holding of equity and approximate level of investment? Management would normally not expect to receive any virtual synthetic rights, except concerning any ratchet that may be granted.

PE sponsors will request that the management’s rights as members be very limited. Management’s rights should be restricted in such a way that it cannot block business operations or an exit even in cases of disputes among shareholders. To such end, managers will often only invest through an investment vehicle, such as limited partners of a limited partnership or through a trustee company that is managed by the sponsor.

Percentage holdings will differ considerably between transactions; participation is often in the aggregate of up to 10%. In secondary transactions, management may reinvest a substantial amount, which justifies a relatively material participation. This amount is usually agreed to on the basis of the net proceeds flowing to the managers from the exit. If management invests for the first time, the investment will essentially take into account management’s financial resources. It is unusual that a sponsor would extend any financing for such purpose.

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Luxembourg is well known for its UCITS brand, which has developed immensely over the last 20 years. Along with this successful development, Luxembourg has also focused on developing products, local infrastructure and corporate structures for alternative investment funds over the last decade. Such efforts have mainly been aiming at encouraging private equity (PE) and venture capital (VC) firms to establish a base in Luxembourg and use it as the preferred domicile for holding companies and fund structures.

Luxembourg is one of the major centres for the PE industry in Europe. Membership in the Luxembourg Private Equity Association has grown to almost 50 PE houses. The state of PE is stable in Luxembourg and is even growing. Many factors make Luxembourg attractive to PE firms. The country can offer political stability, a stable tax environment and a business-oriented attitude not only on the level of private sector service providers but also in terms of the authorities and political leaders.

The AIFM Law

The Alternative Investment Fund Managers Directive (2011/61/EC – the Directive) was implemented into Luxembourg law by means of the Luxembourg law on alternative investment fund managers dated July 12 2013 (AIFM Law). The AIFM Law was one of the first European member state laws to implement the Directive. It aims at a flexible approach in implementing the requirements of the Directive. By the end of June 2014, around 200 applications for the full AIFM licence were pending with the Luxembourg financial supervisory authority, the Commission de Surveillance du Secteur Financier (CSSF) and around 50 licences had already been granted. The registration regime at this time was at around 400 registered alternative investment funds. Such high demand to obtain an AIFM licence seems to be a sign that alternative asset managers as well as PE and VC promoters have identified Luxembourg as a hub for conducting the management and distribution of their funds within the EU.

Besides dealing with AIFM matters, the law also introduced additional advantages to Luxembourg corporate law in the form of the law on risk capital investment companies of June 15 2004 (SICAR) and the Law on specialised investment funds of February 13 2007 (SIF). Both are major conduit vehicles for PE and VC fund structuring in Luxembourg, regulated by the CSSF. Nearly 300 SICARs and nearly 1,700 SIFs have already been approved, many of them with several compartments.

In the wake of the AIFM Law, a new form of limited partnership was introduced: a special limited partnership with no legal personality, known as an SCSp. The limited partners will not be disclosed in the company register, and the corporate governance of the SCSp is flexible and can mostly be tailored to the needs of the general partner in the limited partnership agreement. Although the SCSp does not have a legal personality, it can be inscribed as the owner of assets acquired by the SCSp. It may be created under private seal or by notarial deed, and comes into existence upon signature of the private limited partnership agreement or notarial deed. No minimum capital requirements apply. Further, the management of the SCSp can be carried out by the general partner or third parties (including limited partners) as long as this is clearly set out in the limited partnership agreement. Non-voting securities may be issued by the SCSp. Finally, certain limits on the accessibility by creditors to assets in an insolvency situation are established. A number of SCSpes have been established since July 2013, and overall, it is expected that the SCSp will develop as one of the favourite vehicles for the PE industry. It is also permissible that a SIF or SICAR may take the form of an SCSp.

Marcus Peter of Bonn & Schmidt explains how Luxembourg has made itself into the domicile of choice for holding companies and fund structures.

The PE hotspot

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No recent specific taxation changes have occurred in Luxembourg that might have a bearing on its PE industry. Anti-corruption, environmental, social and governance principles have not generally had a strong influence on PE structures. As to the liability of sponsors, directors, and officers of a PE structure, the general principles under Luxembourg corporate law (which have undergone no recent changes) are applicable. Typically, a sponsor of a PE fund cannot be held liable. Liability, rather, extends to the general partner and management members of a PE fund. Liability may occur for actions that violate applicable law, or for mismanagement behaviour.

Private equity fund structures
Legal structures to establish PE funds are SIFs, SICARs or regular limited partnerships. Such vehicles take the form of either an SCSp, a regular limited partnership with legal personality (SCS) or a partnership limited by shares (SCA). For PE holding structures (investment into one single asset), typically one or more Luxembourg private limited liability companies (SARLs) are incorporated, as such corporate form provides more structuring and governance flexibility than a joint-stock company (SA). The minimum share capital of a SARL is around €12,500 ($17,000) and €31,000 for an SA. Key factors pertaining to the choice of vehicle type are whether regulation is desired or not, where the investors originate, what type of investor is addressed and what investment strategy or policy is pursued.

From a corporate governance point of view, a general partner would typically manage the PE fund. The general partner is normally a Luxembourg SARL, which is managed by a board of managers. The limited partnership agreement might foresee that certain decisions of the general partner require the approval by the general meeting of limited partners. However, this is not common, as the management of the PE fund would normally be at the sole discretion of the general partner. The general partner may, however, create an investment committee or advisory board, which would be composed of members of the main limited partners. Such committee or advisory board would be entitled to render investment advice to the board of managers of the general partner. The board of managers, however, is free to follow such advice or not at its sole discretion.

Regardless of fiduciary duties, board members must act in the best corporate interest of the Luxembourg entity they are managing. Whether the Luxembourg vehicle has any fiduciary duties towards other co-investors in a target portfolio company depends on the corporate and contractual documentation. Often the portfolio company is not situated in Luxembourg but in the country of the target to be acquired by the PE or VC structure. Board members of Luxembourg companies would typically have a board insurance package to cover for certain damages caused by actions of the board members. Insurance companies have focused on this aspect and attractive offers are available.

Acquisition and taxation
In completing acquisition documentation, Luxembourg is substantially involved in the preparation and completion process, as the Luxembourg element in a PE or VC structure is normally the bigger one. Especially if the PE or VC fund is located in Luxembourg, the management of the fund must be fully aware and negotiate all the warranties, covenants and representations in relation to a share purchase agreement to be signed to purchase the target asset. There are no major specific Luxembourg elements for such contractual conditions. This might change if the acquisition is accompanied by a third party (for instance, a bank) financing. In such cases, security needs to be granted and the Luxembourg entities involved in the PE or VC chain of companies are typically part of the security package as obligors or guarantors. The financing documentation needs to take into account to a certain extent the contents of the acquisition documentation. This is because existing financing and security is often released due to the re-financing in the course of the acquisition. It must be ensured that existing security is duly released before new security is taken. Therefore, when acting in a PE deal that runs via Luxembourg entities, one must also often show knowledge in financing transactions to ensure both operations run smoothly. Luxembourg has a quite attractive financial collateral law and its insolvency provisions are favourable to market participants. Both regimes try to keep things simple and ensure that financing, enforcement and insolvency transactions can be conducted in a non-complex and swift manner. This all combines to increase the attractiveness of the jurisdiction.

Finally, another advantage to implementing PE and VC structures via Luxembourg holding companies or investment funds is the high number of double taxation treaties concluded by Luxembourg. The market players in Luxembourg have long-standing experience in tax and fund structuring to meet the investors’ and PE and VC promoters’ needs, regardless of where they are based.

Luxembourg can offer political stability, a stable, tax environment and business-oriented attitude
The fee structure of PE funds typically includes a management and performance fee. Both can be structured in different ways using differing formulas. The method of calculation must be described in an issuing document, or the articles of association or limited partnership agreement. Further, Luxembourg law allows claw-back provisions for interim distributions received in the course of a financial year.

PE holding structures and funds are typically accompanied by a management participation (MPP) or board participation programme (BPP). Such programmes may be run via a specific separate vehicle above the Luxembourg company or fund. However, during the last 12 months, PE firms have been increasingly open to also implementing the MPP or BPP via a Luxembourg vehicle that is either above the Luxembourg fund or holding company. This development is also a strong indicator that the Luxembourg legal and regulatory environment seems to be attractive and favourable to PE and VC structures.

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Peter speaks German, English, Russian, French and Luxembourgish.
SectioN 1 – priVate equity landscape

1.1 How would you describe the current state of private equity activity in your jurisdiction, including the most common forms of private equity transactions?

Investor appetite for private equity (PE) in Nigeria continues to grow exponentially, particularly across financial, telecommunications, insurance, retail, food and beverage, extractive industries, manufacturing and real estate sectors. Common transaction forms include buyouts and restructurings.

1.2 Are there any factors that make your jurisdiction attractive to private equity investors at this time and that will spur private equity investment in the future?

Nigeria’s evolution as a preferred sub-Saharan destination for PE investment is gathering momentum. Factors such as: a rebased gross domestic product (GDP) of approximately $509.9 billion; a GDP growth rate above 7%; a rapidly expanding consumer class in an estimated population of 174 million; the deregulation, privatization and restructuring of strategic sectors; and, a fairly liberal investment regime, offer unique opportunities for PE investment.

SECTION 2 – signifiCant legal developments

2.1 Have there been any recent regulatory developments, including tax developments, in your jurisdiction affecting the raising, formation, governing terms or operation of private equity investment funds or investments made by funds?

Recent PE-specific developments include the SEC’s imposition of mandatory registration and reporting requirements for funds with commitments of $N=1 billion and above. Revised National Pensions Commission (Pen-com) regulations permit the investment of up to 5% of pension funds in PE funds that are SEC-registered and managed by SEC licensed managers. This is subject to stringent restrictions, such as that managers must also subscribe between 1% and 3% or higher of the fund.

The Federal Minister of Industry Trade and Investment inaugurated a dedicated committee, tasked with generating recommendations for developing an optimal environment for PE from a regulatory, economic and fiscal perspective. Hopefully, this signals the government’s increasing recognition of PE’s potential as a catalyst for development.

2.2 Have anti-corruption legislation and/or environmental, social and governance principles affected the approach of private equity investors and/or transaction terms?

Many foreign funds, investors and debt providers are subject to, and required by, regulations in their home jurisdictions to comply with applicable laws in global operating jurisdictions including Nigeria, which also regulate these matters. This has seen the influx of specific representations, warranties and covenants and requirements for compliance with pre- and post-transactional action plans, training and reporting obligations, in transaction documentation.

2.3 Could a private equity sponsor (and/or its directors, officers or employees) be exposed to liability for a portfolio company’s actions or omissions in your jurisdiction and if so, on what legal grounds?

Yes, and such liability could arise under common law and various statutes and regulations. For example, sponsor representatives on the board of the company could incur liability: (i) (civil) for acting outside the scope of their authority (Companies and Allied Matters Act 2004 or CAMA); (ii) (criminal) for not applying loan monies or property received for specified purposes or as advance contractual payments, as required; (iii) (civil) for loss or damage sustained by untrue statements or mis-statements in a prospectus; (iv) unlimited liability if so specified by its constitutional documents (CAMA); (v) as principal officers or managers of the company under tax laws (Companies Income Tax Act 2007 or CITA), for the assessment and payment of tax by the company, and ensuring its compliance; and criminal liability for aiding the making or delivery of false returns, preparing false accounts or unlawfully refusing or neglecting to pay tax; (vi) as directors, managers, secretaries or other similar officers of such company where the company commits an offence under certain tax laws (Federal Inland Revenue Service Establishment Act), unless the offence takes place without their knowledge, consent or conviction; (vii) for various offences before, and in the course of, winding up; and (viii) under the ISA, as directors and officers for the company’s failure to comply with specific ISA and SEC rules’ provisions, such as the requirement to obtain certain regulatory approvals.

section 3 – fund formation and structure

3.1 Please describe the typical legal structure used to establish private equity funds, including the primary securities law considerations in private equity fund formation.

Available structures are limited liability companies under CAMA and general or limited partnerships or the newer limited liability partnerships under the provisions of the Partnership Law of Lagos State 2009 (as amended). Many PE funds have traditionally been structured as limited partnerships in which the general partner (GP) is liable for all debts and obligations of the partnership and the liability of limited partners (LPs) is limited to the extent of their respective contributions.

SEC Rules/ISA considerations include mandatory registration requirements for funds with commitments of $N1 billion and above and their managers, minimum share capital requirements for the manager, restrictions on funds solicitation from the general public and qualified (sophisticated) institutional investors and restrictions on the investment of more than 30% of fund assets in any single investment.

3.2 How are carried interest arrangements typically structured and is there a prevailing methodology for calculating the sponsor’s carried interest?

Carried interest arrangements are typically structured as separate vehicles into which the carried interest will be paid. The methodology for calculating the GP’s carried interest is usually a matter of negotiation. Profit splits 80:20 between LPs and GPs are not unusual.
3.3 Are fund investors typically subject to claw back or a return of distributions to cover their respective allocations of fund liabilities, such as indemnification payments?

We have seen provisions that permit distributions payable to investors, to be attributed to indemnification payments due from funds to GPs. They can either be clawed back from fund receipts from disposals of investments in portfolio companies, or added to undrawn commitments and, therefore, made available for re-drawing by the fund. Documentation may also be structured to allocate net income, capital gains and capital losses of the funds between investor accounts such that the balances in such accounts reflect investors’ respective distribution entitlements.

Section 4 – STRUCTURE OF ACQUISITION VEHICLE

4.1 What type of entity is typically used as the acquisition vehicle for private equity investments in your jurisdiction? What are the key factors that determine the choice of entity?

Limited liability companies are most typically used as acquisition vehicles for PE investments. Shareholder liability is generally limited to the unpaid balance (if any) on shares held; shares are readily transferable, and such companies can sue and be sued in their own name and have perpetual succession.

4.2 Does the structure of the acquisition vehicle vary depending on the nature of the investors in the private equity purchaser’s fund?

Private limited liability companies must have a maximum of fifty shareholders, and are most commonly used for closed-ended funds, while public companies (the membership of which is unlimited) are preferred by open-ended funds.

4.3 Describe how the choice of acquisition vehicle affects the nature of the incentive equity compensation that can be offered to management.

Share options and equity incentive schemes are usually contractually agreed with key management, and not determined by the choice of acquisition vehicle used.

If the acquisition vehicle is a limited liability company, however, incentive equity compensation could be in the form of an award of performance shares.

If the acquisition vehicle is a partnership, no incentive equity compensation can be granted, but such compensation could be in the form of participation in profit distributions.

Section 5 – ACQUISITION STRUCTURE

5.1 What are the typical structures used by private equity sponsors to acquire portfolio companies in your jurisdiction? What are the major considerations that govern this decision?

The same structures and considerations as outlined in section 4.1 apply.

5.2 What are the major issues that drive deal timing in your jurisdiction, including disclosure obligations, financing and regulatory approval requirements?

Delays can arise in the due diligence process from inadequate information or documents, and in obtaining mandatory pre- and post-transaction approvals from regulators (such as the SEC and sector-specific regulators such as the Central Bank of Nigeria, Pencom, the National Insurance Commission, the National Agency for Food and Drug Administration and Control, the Department for Petroleum Resources and the Nigerian Communications Commission). Unrealistic deal timelines can increase the pressure to close – which in turn can lead to potentially harmful compromises.

Section 6 – GOVERNANCE

6.1 Are there any legal requirements in your jurisdiction that would prevent or otherwise affect the ability of a private equity acquirer to designate members of the board and/or management of its portfolio companies?

The appointment of directors generally requires a majority (50% plus 1) vote at shareholders’ and (in the case of a casual vacancy), board meetings. CAMA, however, permits the constitutional documents of a company to empower any person, whether a shareholder or director or not, to appoint or remove directors and other officers of a company. The PE acquirer can, subject to agreeing this as a term of its investment, utilise such devices to designate the board and management of portfolio companies. There are also sector-specific restrictions such as section 32 of the Nigerian Oil and Gas Industry Content Development Act 2010, which provides that no more than a maximum of 5% of management positions may be retained by operators or project promoters for expatriates, subject to the approval of the Nigerian Content Monitoring Board.

6.2 Are there any legal risks for the private equity acquirer in designating such members?

See section 2.3.

6.3 Are veto rights over major corporate actions (such as dissolution and winding up, merger or consolidation, significant acquisitions or dispositions, incurrence of material indebtedness, or changing the business of the company) typical rights held by private equity acquirers? Are there any limitations or prohibitions on such rights?

CAMA prescribes special resolutions (approval of 75% of shareholders present and voting at general meetings) as a minimum for change of business, dissolution and winding up and mergers as a mandatory requirement. Acquisitions and significant property transactions involving directors and connected persons require approval in the form of an ordinary resolution (50% plus at least 1 share). Minority PE investors may utilise mechanisms such as quorum requirements to ensure their participation at such meetings.

6.4 Do private equity funds or any board members they appoint, have any fiduciary or other duties to minority equity-holders or other stakeholders of a portfolio company? Eg are there any prohibitions against acquisitions of, or investments in, competing or complimentary businesses?

Regardless of who appoints them, all directors have fiduciary obligations to the portfolio companies on the board of which they sit. Restrictions on participation in competing or complimentary businesses are usually contractually agreed (for instance in shareholders’ agreements).

Section 7 – DEAL TERMS

7.1 What pricing structures are typically preferred by private equity sponsors in your jurisdiction?

Pricing is usually contractually agreed and varies from one transaction to another.

7.2 What is the typical scope of the representations and/or warranties, covenants, undertakings and indemnities provided by a private equity seller and the target company’s management team to an acquirer in an acquisition agreement?

The terms (and any applicable limits) are contractually negotiated, and vary widely, but would usually include due incorporation, authorisation, compliance with applicable laws, title (to shares and assets), encumbrances, third-party consents and waivers (contractual and regulatory), insurance, disputes, tax liabilities, restrictive financial and operational covenants, and the provisions discussed in section 2.2 above.
7.3 To what extent are purchaser funds at risk for the equity capital committed to a transaction?
Typical investment risks would include scenarios in which the investee company either does not generate sufficient distributable profits or is making losses.

7.4 What are the customary time limits and other limitations on liability applicable to representations and/or warranties given by a private equity seller and the target company’s management team?
Where these are contractually agreed, they can range from six months to two years. Statutory limitations are six years for most simple contracts and 12 years for contracts that are under seal. There is also a six-year period during which the Federal Inland Revenue Service can make a claim in respect of an under-assessment of taxes, but no limit where such under-assessment is as a result of fraud, neglect or wilful default.

7.5 What methods are typically used to fill any ‘warranty gap’ in your jurisdiction? Is warranty and indemnity insurance commonly used in private equity transactions in your jurisdiction?
Escrow retention of agreed portions of transaction consideration is not unusual. Warranty and indemnity insurance is not yet, as far as we are aware, commonplace.

7.6 What conditions to a private equity sponsor’s obligation to complete an acquisition are typically included in the acquisition agreement? Are these conditions usually substantially aligned with the conditions included in the financing documentation?
Typical completion conditions may include: the execution of all key transaction agreements; the provision of corporate, regulatory and contractual approvals (or, where applicable, waivers and consents); and, undertakings to assist with procuring a certificate of capital incorporation evidencing the importation of any loan or equity funds into Nigeria, payment of consideration or financing.

7.7 To what extent are purchaser funds at risk for the equity capital committed to a transaction? Are third-party beneficiary rights or other enforcement rights typically made available to the seller?
No; our experience is that third-party beneficiary or enforcement rights are not typically made available to the seller, but may be contractually negotiated.

7.8 How is a management team’s equity participation typically structured, including customary types of equity interest?
Structures vary. We are aware of requirements that management teams invest (typically) 1% to 2% (and in some instances up to 5%), of remuneration alongside fund investments, most often in ordinary shares, as a means of ensuring that their interests remain aligned with those of the fund investors. Upon exceeding specified or pre-agreed milestones or performance benchmarks in relation to specific funds, managers with whom we spoke indicated a carry or performance fee of as much as 20%, which will often be pre-agreed with management fees at fundraising.
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Elias-Adebawale has written and presented papers on private equity, foreign investment and the local content requirements affecting participants in the Nigerian petroleum sector, and is a regular contributor to the International Law Office's Energy and Natural Resources Newsletter. She also co-wrote an article entitled *The Regulation of Private Equity in West Africa – Emerging Trends* with Norton Rose South Africa in the winter 2011/12 edition of the Legal & Regulatory Bulletin of Emerging Markets Private Equity Association (EMPEA). She represents the firm on EMPEA’s Legal and Regulatory Council.

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Turkey

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Section 1: PRIVATE EQUITY LANDSCAPE

1.1 How would you describe the current state of private equity activity in your jurisdiction, including the most common forms of private equity transactions?

Private equity (PE) investments in Turkey have grown immensely over the past decade. Turkey strode through the global economic recession and the 2013 Gezi protests unscathed, which can mostly be put down to a larger macroeconomic process. This included a steady growth of GDP at around 8%, a reasonably lower inflation rate compared to almost triple that 15 years ago. These factors have also helped Turkey’s consumer economy to thrive.

Turkey is a sophisticated market for PE transactions. With the rise of angel investors and venture capitals, the Turkish market has further developed in early stage financing. However, corporate acquisitions, joint ventures and minority investments undoubtedly dominate the PE market. Corporate acquisitions in Turkey generally involve PE funds that invest directly in target companies or through joint ventures with local partners, seeking majority interests. Alternatively, minority investments with control over the target by means of shareholders’ agreements are very common. In order to drive the investment forward and minimise liabilities, special purpose vehicles (SPVs) are adopted.

1.2 Are there any factors that make your jurisdiction attractive to private equity investment at this time or that will spur private equity investment in the near term?

PE sponsors benefit from a range of asset classes and strategies in Turkey. The new Turkish Commercial Code (TCC) offers foreign investors with similar rights as local investors. With the rise of PE transactions, there has been an increase in the availability of alternative debt financing with borrower-friendly terms and a range of feasible exit routes. The recent investor-friendly legal developments have offered both local and foreign investors with a multitude of benefits and practical solutions.

Section 2 – SIGNIFICANT LEGAL DEVELOPMENTS

2.1 Have there been any recent regulatory developments, including tax developments, in your jurisdiction affecting the raising, formation, governing terms or operation of private equity investment funds or investments made by funds?

In 2012, the TCC underwent comprehensive legal changes, which overall is welcomed by PE investors. The new law offers a more sophisticated approach and numerous advantages in a broad range of areas, particularly in relation to corporate governance, squeeze-outs, and shareholder agreements.

The TCC has introduced far-reaching corporate governance and transparency requirements for both public and private companies. The code brings about a range of provisions that encourage professional management and the ability to adapt sophisticated shareholder arrangements sought by PE investors. Further, a transfer can be rejected by companies with a share buyback, at a fair value determined by the court.

PE investors can now benefit from two new squeeze-out procedures, merger squeeze-out and squeeze-out for bad faith. The new law enables majority shareholders with voting rights and at least 90% shares to squeeze out minority shareholders who prevent the operation of the company, act in bad faith, and create hardship or act recklessly. Majority shareholders can also apply the squeeze-out method through a merger agreement.

The TCC introduces a prohibition on financial assistance. This provision has been widely criticised, as the company cannot issue a corporate guarantee or surety for acquisition-related loan repayments. The article states that joint stock companies may not advance funds, nor make loans, nor provide security, with a view to the acquisition of its shares by a third party.

2.2 Have anti-corruption legislation and/or environmental, social and governance principles affected the approach of private equity investors and/or transaction terms?

In Turkey, there is a general and global trend which gives more emphasis to anti-corruption rules. As this is an increasingly sensitive matter, the principles affect the approach of the investors, especially foreign investors. One of the biggest challenges for PE transactions involve compliance matters, which have become an important component of the due diligence review. Turkey has witnessed a number of unsuccessful transactions due to compliance issues. Thus, in order to avoid such investment challenges, buyers take protective measures with transaction documents against the target’s non-compliance with laws.

2.3 Could a private equity sponsor (and/or its directors, officers or employees) be exposed to liability for a portfolio company’s actions or omissions in your jurisdiction and if so, on what legal grounds?

One of the more significant innovations introduced by the TCC is the concept of ‘group of companies’. Here, the law restricts a parent company, in any legal form (such as joint stock or limited liability) from using its controlling power for the disadvantage of one or more of its subsidiaries for the benefit of the others. If the parent company conducts such a transaction, it must equalise the cost to the disadvantaged subsidiary by providing an equivalent opportunity in the same fiscal year, with a specific explanation of how and when this loss will be recovered. Otherwise, the shareholders and the creditors of such subsidiary can file a claim against the parent company and its board of directors.

The TCC provides an additional liability for parent companies in the event that a group has built its reputation in such a way that would lead the public or consumers to trust the group or the group’s brands. If a subsidiary uses this reputation with the group’s name, logo or in any other way that would give the impression to the public or consumers that the subsidiary’s products or services are under the guarantee of the parent, then the parent is liable for the losses incurred by the consumers due to such trust.

Section 3 – STRUCTURE OF ACQUISITION VEHICLE

3.1 What type of entity is typically used as the acquisition vehicle for private equity investments in your jurisdiction? What are the key factors that determine the choice of entity?

The typical legal structures in Turkey are joint stock companies and limited liability companies. Non-Turkish tax resident acquisition vehicles are also common for direct investments in Turkey.

The key factors that determine the choice of entity and how many entities will be involved, are tax requirements, and requirements of the finance provider if financing is required. If there is a partnership involved or if the PE is a minority investor, the ability to reflect and enforce the minority rights, corporate governance rules and other shareholders’ arrangements could be another key factor.
3.2 Does the structure of the acquisition vehicle vary depending on the nature of the investors in the private equity purchaser’s fund? Depending on the tax requirements, certain investors may prefer non-Turkish tax resident acquisition vehicles.

3.3 Describe how the choice of acquisition vehicle affects the nature of the incentive equity compensation that can be offered to management.

Incentive equity compensation schemes are relatively new in Turkey. Unlike certain other jurisdictions, the corporate structure of Turkish companies is not as suitable to provide this kind of scheme. Nevertheless, incentive equity compensation schemes are becoming more common and they are supported by contractual undertakings by the shareholders, as provision of such schemes usually require action by the shareholders. These schemes are usually contractual or involve the target companies and the choice of acquisition vehicle should not affect the nature of these schemes.

Section 4 – ACQUISITION STRUCTURE

4.1 What are the typical structures used by private equity sponsors to acquire portfolio companies in your jurisdiction? What are the major considerations that govern this decision?

It is typical for PE sponsors to use a holding company that directly, or through another company, holds the target company shares, in which case the PE itself and the sponsors of the target (if any) participate as shareholders. Another common structure is that the PE uses a holding company to hold an acquisition vehicle, which directly participates in the target company.

The major consideration that governs this decision is tax efficiency both on dividends and on exits.

4.2 What are the major issues that drive deal timing in your jurisdiction, including disclosure obligations, financing and regulatory approval requirements?

The major factors that drive deal timing are negotiations between the parties, regulatory consents (antitrust and other sector-specific regulatory approvals) and the due diligence process.

Section 5 – GOVERNANCE

5.1 Are there any legal requirements in your jurisdiction that would prevent or otherwise affect the ability of a private equity acquirer to designate members of the board and/or management of its portfolio companies? Are there any legal risks for the private equity acquirer in designating such members?

Under Article 553 of the TCC, board members may be held liable towards the shareholders and the creditors of the company for their negligent acts. Accordingly, the board members are required to act with the care and diligence expected from a so-called cautious executive and to protect the interests of the company while performing their duties in accordance with the business judgment rule.

5.2 Are veto rights over major corporate actions (such as dissolution and winding up, merger or consolidation, significant acquisitions or dispositions, incurrence of material indebtedness, or changing the business of the company) typical rights held by private equity acquirers? Are there any limitations or prohibitions on such rights?

PE acquirers that are shareholders with at least 10% of the share capital of a joint stock company, generally hold veto rights over major corporate actions. Such rights include: calling the General Assembly to meet; adding a matter to the agenda of the General Assembly; requesting the General Assembly to appoint a special auditor; objecting to the release of founding shareholders, board members and auditors; requesting the termination of the company; and, requesting the postponement of discussions and approval of the company’s financial statements.

Any decision that will increase the shareholders’ undertakings or obligations, transfer the registered address of the company abroad, or change the scope of activities or purpose of the company, require unanimity of the total share capital of the joint stock companies. There are also other matters such as capital reduction, sale of a substantial asset, termination of the company that require affirmative votes of the 75% of the total share capital. In addition to these, it is also possible to create share groups and allocate certain privileged rights or veto rights to the holders of such privileged share groups. This is the most common method applied by PEs in minority investments or joint ventures.

5.3 Do private equity funds or any board members they appoint, have any fiduciary or other duties to minority equity-holders or other stakeholders of a portfolio company? Eg are there any prohibitions against acquisitions of, or investments in, competing or complimentary businesses?

Board members have the obligation not to compete with the company’s business, unless they are permitted to do so. There may also be certain customary contractual undertakings by board members not to acquire or invest in competing businesses.

Section 6 – DEAL TERMS

6.1 What pricing structures are typically preferred by private equity sponsors in your jurisdiction?

The most common mechanism used in PE deals in Turkey is a debt-free cash-free price mechanism. However, the locked-box price mechanism has been preferred in some deals recently, but it is still quite rare.

6.2 What is the typical scope of the representations and/or warranties, covenants, undertakings and indemnities provided by a private equity seller and the target company’s management team to an acquirer in an acquisition agreement?

PE sellers usually provide representations and warranties regarding title, capacity and enforceability. Generally, the target company’s management will be expected to provide business warranties. Depending on the involvement of the PE in the management of the target company and the negotiations, the PE sellers may also need to provide business warranties.

6.3 What are the customary time limits and other limitations on liability applicable to representations and/or warranties given by a private equity seller and the target company’s management team?

Fundamental warranties, such as title capacity, are not usually subject to any limitations. Business warranties are subject to time limitations (usually between 12 to 24 months). There is also a liability cap, which is determined as a certain percentage of the purchase price. The percentage and the amount of the liability cap varies depending on the negotiations. A minimum threshold for bringing claims is also common.

6.4 What methods are typically used to fill any ‘warranty gap’ in your jurisdiction? Is warranty and indemnity insurance commonly used in private equity transactions in your jurisdiction?

The most common way to bridge any warranty gap is to deduct the purchase price to address a specific potential liability. Warranty and indemnity insurance is not yet common in Turkey.
6.5 What conditions to a private equity sponsor’s obligation to complete an acquisition are typically included in the acquisition agreement? Are these conditions usually substantially aligned with the conditions included in the financing documentation?

Typical completion conditions are antitrust approvals and other sector-specific regulatory approvals. Material adverse change clauses are usually included in acquisition agreements. It usually depends on the amount of the financing to be used in the acquisition for the conditions precedent to be aligned in the financing documents.

6.6 To what extent are purchaser funds at risk for the equity capital committed to a transaction? Are third-party beneficiary rights or other enforcement rights typically made available to the seller?

The PE fund usually commits to funding the acquisition vehicle. If all other conditions are satisfied and the PE still fails to perform its commitment, the sellers can enforce this commitment.

The vehicle may be given actual equity, or a contractual arrangement where the shareholders of the target company and the PE undertake to provide the management with a bonus, which is linked to the share purchase price of the target company and a deemed equity vested to them for the time period they work in the target. The management is entitled to a certain number of shares for each year, month or quarter of a year they work for the target. Such percentage depends on the negotiation of the parties.

About the author
Gamze Cigdemtekin has a wide range of transactional expertise covering M&A, corporate, energy, infrastructure, project finance and private equity. She has advised on a vast number of corporate and finance transactions in Turkey, with a particular focus on M&A, private equity and power projects on a project finance basis. Her expertise also extends to competition law. Cigdemtekin has represented major international and Turkish clients in several sectors, including energy, banking and insurance, manufacturing, and cements, as well as chemicals and pharmaceuticals. Leading legal directories recognise Cigdemtekin as a leading M&A lawyer in Turkey, and she was also listed as one of the top lawyers in Forbes Turkey’s survey as a result of a number of cases handled before the Competition Authority.
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Section 1 – PRIVATE EQUITY LANDSCAPE

1.1 How would you describe the current state of private equity activity in your jurisdiction, including the most common forms of private equity transactions?

Private equity (PE) sponsors, particularly larger alternative asset managers, have been buoyed by: an increasingly diverse range of asset classes and strategies; the availability of debt financing alternatives (including high-yield bonds and non-bank debt); multiple viable exit routes; an improved (albeit bifurcated) fundraising environment; a robust secondaries market; and improving macro-economic conditions.

The last six months have seen a broad range of PE transactions, including leveraged buyouts, refinancings, flotations and follow-on sales, trade sales, secondary buyouts, bolt-on deals and secondary transactions. Sponsor-backed flotations have been particularly prevalent.

1.2 Are there any factors that make your jurisdiction attractive to private equity investment at this time or that will spur private equity investment in the near term?

The UK offers a business friendly, free market economy. It has well-established and stable political, economic and legal systems, a leading global financial centre, relatively low corporation tax and inflation and a well-educated, English-speaking workforce.

The recent flurry of flotations emphasises the UK’s attractiveness for PE investment which may be further spurred by the strong pipeline of PE-backed UK companies to be sold and interest from overseas investors.

Section 2 – SIGNIFICANT LEGAL DEVELOPMENTS

2.1 Have there been any recent regulatory developments, including tax developments, in your jurisdiction affecting the raising, formation, governing terms or operation of private equity investment funds or investments made by funds?

Effective from July 22 2013, the EU’s Alternative Investment Fund Managers Directive (AIFMD) imposes significant new regulatory requirements on alternative investment fund managers (AIFMs) operating within the EU, including regarding required regulatory authorisations, conduct of business, regulatory capital, valuations, disclosures and marketing. Under the AIFMD, authorised EU AIFMs can market EU-based alternative investment funds (AIFs) to EU investors through a pan-European marketing passport. This marketing passport is unavailable to non-EU AIFMs or EU AIFMs managing non-EU AIFs until at least 2015.

Recent tax developments aimed primarily at countering perceived avoidance include: (i) a general anti-abuse rule; (ii) recharacterisation of certain members of UK limited liability partnerships (LLPs) as employees for tax purposes, potentially affecting fund managers structured as LLPs; and (iii) rules targeting certain artificial allocations of the profits and losses of partnerships (not just LLPs) with both individual and non-individual members.

2.2 Have anti-corruption legislation and/or environmental, social and governance principles affected the approach of private equity investors and/or transaction terms?

Sponsors are increasingly focused on compliance with anti-corruption legislation and environmental, social and governance principles, particularly given increasing regulatory scrutiny of corporate conduct and potentially significant financial penalties and reputational damage resulting from non-compliance.

This trend has been reflected in transaction terms by a general extension of buyers’ contractual protection against target groups' non-compliance with laws.

2.3 Could a private equity sponsor (and/or its directors, officers or employees) be exposed to liability for a portfolio company’s actions or omissions in your jurisdiction and if so, on what legal grounds?

A sponsor and its directors, officers or employees may be held liable for its portfolio company's actions or omissions, including in the following circumstances:

- a sponsor’s officer could incur liability as a shadow director of its portfolio company for (among other things) fraudulent or wrongful trading under the Insolvency Act 1986 or be disqualified for unfairness under the Company Directors Disqualification Act 1986;
- a sponsor could incur liability under the EU Parental Liability Doctrine, which presumes liability of the sponsor on a joint and several basis with its portfolio company for any breach of EU antitrust law by the latter, where the sponsor has full ownership or decisive influence over, the portfolio company's commercial conduct;
- a sponsor’s senior officer who participates in the corrupt actions of, or consents to or connives with, its portfolio company could incur liability under the Bribery Act 2010; and
- a sponsor could incur Bribery Act liability for failing to implement adequate procedures for its portfolio company where the latter acts on behalf and for the benefit of the sponsor.

Section 3 – FUND FORMATION AND STRUCTURE

3.1 Please describe the typical legal structure used to establish private equity funds, including the primary securities law considerations in private equity fund formation.

PE funds are typically formed as limited partnerships since they are tax-efficient, offer flexible internal governance and confer limited liability status on limited partners. General partners of certain English limited partnerships are now required to file publicly available accounts.

Subject to certain size limits, UK AIFMs must be authorised by the Financial Conduct Authority (FCA) to manage AIFs. To market an EU AIF to UK investors, the AIFM must apply to the FCA for permission. If the UK AIFM intends to market the AIF in other member states, it should notify the FCA, who will then notify the competent authorities.

Non-EU AIFMs or EU AIFMs managing non-EU AIFs must rely on the national private placement regimes (NPPRs) of individual member states, provided certain additional AIFMD and member state conditions are satisfied. Before marketing under the UK’s NPPR, AIFMs must notify the FCA.

AIFMs marketing in the UK with the passport or under the NPPR must...
ensure the offer falls within an exemption to the Prospectus Directive and the UK’s financial promotion regime regarding marketing to retail investors.

3.2 How are carried interest arrangements typically structured and is there a prevailing methodology for calculating the sponsor’s carried interest?

Carried interest is typically structured through a limited partnership, with executives or their vehicles as limited partners. The carried interest limited partnership is in turn a special limited partner in the fund limited partnership. It is typically calculated on a whole-of-fund basis – the entitlement arises after investors have received a return of their drawn-down capital, plus any preferred return accrued.

3.3 Are fund investors typically subject to claw back or a return of distributions to cover their respective allocations of fund liabilities, such as indemnification payments?

Governing fund documentation typically states investors may be obliged to return distributions to satisfy indemnification obligations and certain other fund liabilities, often subject to time and quantum limitations. Returned distributions are generally considered when determining whether any sponsor’s carried interest clawback is due.

Section 4 – STRUCTURE OF ACQUISITION VEHICLE

4.1 What type of entity is typically used as the acquisition vehicle for private equity investments in your jurisdiction? What are the key factors that determine the choice of entity?

The acquisition vehicle (Bidco) is typically a private limited liability company resident for tax purposes in the UK, although non-UK tax resident Bidcos are also common for certain investments. Bidco’s jurisdiction of incorporation can vary based on the desired corporate flexibility and may be onshore or offshore.

The preferred overall acquisition structure and involvement of other entities primarily depends on: (i) the tax considerations of the sponsor, management and target; (ii) the finance provider(s)’ requirements; and (iii) the expected profile of investor returns.

4.2 Does the structure of the acquisition vehicle vary depending on the nature of the investors in the private equity purchaser’s fund?

The nature of the investors in the sponsor’s fund would not typically change the answer to question 4.1, unless there are additional regulatory considerations, but may impact the decision to incorporate Bidco in the UK.

4.3 Describe how the choice of acquisition vehicle affects the nature of the incentive equity compensation that can be offered to management.

The choice of Bidco may affect the tax treatment of the incentive payment, but the fundamental commercial nature of the management incentive and economics of equity compensation will be broadly the same whatever vehicle is used (see 7.7).

Section 5 – ACQUISITION STRUCTURE

5.1 What are the typical structures used by private equity sponsors to acquire portfolio companies in your jurisdiction? What are the major considerations that govern this decision?

PE buyouts are commonly structured using a holding company (Topco) – the sponsor and management are respectively the majority and minority shareholders – and a wholly-owned subsidiary of Topco (Bidco), which acquires and holds the target’s shares. Intermediate holding companies may be inserted between Topco and Bidco for tax or financing purposes. Topco is commonly an offshore vehicle but UK tax resident.

Sponsors typically use small proportions of equity finance to subscribe for preferred ordinary shares in Topco. They invest the balance as shareholder debt, commonly structured as payment-in-kind loan notes issued by Topco, deductions for interest payments on which can be surrendered against the target group’s profits. These shares and shareholder debt are together known as the institutional strip.

An important tax consideration is the reduction or elimination of tax costs on flows of cash back from the portfolio companies to the PE fund, whether on dividends, interest payments or on exit. UK tax considerations effectively reduce withholding from dividends paid by portfolio companies to the UK and the UK does not generally impose tax on the receipt of dividends or withholding tax from dividends. Using a UK Topco may be attractive where the focus is not on capital growth.

5.2 What are the major issues that drive deal timing in your jurisdiction, including disclosure obligations, financing and regulatory approval requirements?

Deal timing is primarily driven by regulatory approvals (usually antitrust and sector-specific approvals) and, given the prevalence of locked-box pricing mechanisms (see 7.1), the preparation of financials.

Section 6 – GOVERNANCE

6.1 Are there any legal requirements in your jurisdiction that would prevent or otherwise affect the ability of a private equity acquirer to designate members of the board and/or management of its portfolio companies? Are there any legal risks for the private equity acquirer in designating such members?

There are no such legal requirements. However, when designating members of its portfolio company's board or management, a sponsor should seek to ensure that: (i) the company complies with applicable laws and has sufficient substance from a tax perspective; and (ii) the company’s directors, officers and employees could not be considered shadow directors or otherwise be held liable for it's acts or omissions.

6.2 Are veto rights over major corporate actions (such as dissolution and winding up, merger or consolidation, significant acquisitions or dispositions, incurrence of material indebtedness, or changing the business of the company) typical rights held by private equity acquirers? Are there any limitations or prohibitions on such rights?

Sponsors commonly have veto rights over major corporate, commercial and financial matters.

Veto rights will generally be void if they constitute an unlawful fetter on any statutory powers or are contrary to public policy. Generally, appropriate structures can be put in place to ensure that customary veto rights can be effective.

6.3 Do private equity funds or any board members they appoint, have any fiduciary or other duties to minority equity-holders or other stakeholders of a portfolio company? Eg are there any prohibitions against acquisitions of, or investments in, competing or complimentary businesses?

A PE fund is not subject to such duties under English company law.

Board appointees generally owe duties to the company, but may, in limited circumstances, owe duties to shareholders, particularly regarding information disclosure. Duties may also be owed if the portfolio company is insolvent or verging on insolvency or if a specific relationship (such as principal and agent) is established between the sponsor-nominated directors and the shareholders. Finally, shareholders may be entitled to bring derivative actions on the company’s behalf.

Under the AIFMD, PE funds owe additional obligations to portfolio companies and their stakeholders. When an AIF acquires control (over 50% of the voting rights) of certain unlisted companies, the AIFMDF requires the AIFM of that AIF to comply with certain restrictions on distributions, capital reductions, share redemptions and buybacks by the target for the fol-
lowing 24 months and to disclose to shareholders (and employees’ repre-
sentatives or employees, as applicable): (i) acquisition of control by the AIF;
and identities of the AIFMs managing the AIF; (ii) policies regarding pre-
venting and managing conflicts of interest and communications relating to
the company, particularly its employees; and (iii) its intentions regarding
the company’s future business and likely repercussions on employment.

Antitrust laws may prohibit the acquisition of, or investment in, competing
or complimentary businesses.

Section 7 – DEAL TERMS

7.1 What pricing structures are typically preferred by private equity
sponsors in your jurisdiction?
PE sellers usually favour locked-box pricing structures, which offer price
certainty from the outset, control over financial information, potentially re-
duced contractual liability, cost savings and prompt distribution of sale pro-
cceeds to investors post-closing. Completion accounts is the other pricing
mechanism commonly encountered.

7.2 What is the typical scope of the representations and/or
warranties, covenants, undertakings and indemnities provided by a
private equity seller and the target company’s management team to
an acquirer in an acquisition agreement?
In an acquisition agreement, a PE seller usually only provides warranties re-
garding title, capacity and enforceability and (assuming a locked-box pricing
structure) a no-leakage undertaking. The PE seller may also provide pre-
completion undertakings regarding the target business.

The target’s management will often provide business warranties, typically
under a separate management warranty deed. Their primary purpose is to
elicit full disclosure regarding the target during the due diligence process.

7.3 What are the customary time limits and other limitations on
liability applicable to representations and/or warranties given by a
private equity seller and the target company’s management team?
A PE seller’s warranties are usually either subject to a cap equal to the ag-
gregate purchase price, or uncapped (see 7.2).

Managers can limit their liability under the warranties by: (i) giving them
severally (each manager is only liable for its proportionate share of liability
for any claim) and subject to awareness; (ii) capping maximum liability for
any warranty claims; and (iii) negotiating a (reasonably high) threshold and
de minimis and a short time-limit for bringing claims.

7.4 What methods are typically used to fill any warranty gap in your
jurisdiction? Is warranty and indemnity insurance commonly used
in private equity transactions in your jurisdiction?
Warranty gaps can be bridged by a purchase price reduction to address spe-
cific potential liabilities or by managers giving business warranties: (i) on
the basis that specific warranty claims will only be made against a seller-
funded escrow fund or retention account; (ii) subject to warranty and in-
demnity insurance; (iii) as consideration for a financial incentive; and/or,
(iv) subject to a cap equal to a proportion of their individual sale proceeds.

Buyer warranty and indemnity insurance policies have become more afford-
able and are increasingly common.

7.5 What conditions to a private equity sponsor’s obligation to
complete an acquisition are typically included in the acquisition
agreement? Are these conditions usually substantially aligned with
the conditions included in the financing documentation?
To enhance deal certainty, conditions to completion are typically limited to
necessary regulatory approvals and do not generally include financing con-
ditions. PE sellers also continue to strongly resist material adverse change
clauses. The condition in the acquisition agreement and the financing and
documentation are usually substantially aligned.

7.6 To what extent are purchaser funds at risk for the equity capital
committed to a transaction? Are third-party beneficiary rights or
other enforcement rights typically made available to the seller?
At signing, the PE fund typically gives a direct commitment to the seller to
fund Bidco with the equity capital committed to the transaction, subject
only to satisfaction of the conditions in the acquisition agreement and the
financing being available. The seller can enforce this commitment directly
against the PE fund to the extent it becomes unconditional and the PE fund
fails to fund Bidco.

7.7 How is a management team’s equity participation typically
structured, including customary types of equity interest, percentage
holding of equity and approximate level of investment?
Management equity structures and types depend on: the sponsor’s priorities;
managers’ bargaining strength; senior managers’ tax residence and domicile;
and tax treatment of relevant equity interests.

Senior management increasingly prefers to receive carried interest through
partnership interests. Where no partnership exists in the structure and for
less senior executives, shares can be subscribed (sweet equity).

Managers beneath the higher bands may be invited to participate in man-
agement incentive plans or to become employee shareholders.

Except in large buyouts, management’s percentage holding of Topco’s ordi-
nary shares is typically 5% to 15%. Management is usually expected to make
a significant financial investment in the target group to ensure they remain
incentivised to create further value.
About the author

Lascelles is a partner based in Skadden’s London office, where his practice concentrates on cross-border mergers and acquisitions, joint ventures and private equity transactions. He is co-head of Skadden’s global private equity group.

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Private equity (PE) and venture capital (VC) investment is thriving in Brazil. According to PwC’s last quarterly M&A report, in 2013, almost half (47%) of the 811 Brazilian deals involved PE and VC investors. Despite challenges in fundraising, the industry has accumulated significant capital commitments and is expected to continue to drive deal activity.

Although the vast majority of PE and VC investments are still made in private companies, in recent years there has been an increasing amount of investment in pre-IPO (initial public offering) companies and in connection with the delisting of public companies.

PE and VC investment is most active in sectors such as education, health services and technology.

1.2 Are there any factors that make your jurisdiction attractive to private equity investment at this time or that will spur private equity investment in the near term?

The valuations and the revenue growth of Brazilian companies, which are still very attractive and offer the potential for suitable rates of return, are motivating PE and VC investments.

In certain recent deals, investors have obtained Brazilian real-denominated bank financing, adding leverage to the available tools for enhancing investment returns while also avoiding foreign exchange rate risk and enabling tax efficiencies related to deductibility of interest payment.

Certain qualified investment funds (see 4.2) also offer a full exemption on Brazilian capital gains taxes for their investors.

Although the equity capital markets remain essentially closed, PE and VC investors in Brazil have a successful track record of exiting their investments by means of public share offerings. When the equity markets eventually reopen, this exit option is likely to be valuable.

Section 2 – SIGNIFICANT LEGAL DEVELOPMENTS

2.1 Have there been any recent regulatory developments, including tax developments, in your jurisdiction affecting the raising, formation, governing terms or operation of private equity investment funds or investments made by funds?

The Comissão de Valores Mobiliários (CVM), the Brazilian securities commission, has recently issued regulations releasing Fundos de Investimento em Participações (FIPs, the most common fund form for PE and VC investment) from the requirement that they hold certain governance rights in investee companies, so long as such investees represent no more than 35% of total fund assets.

CVM regulations also have been amended recently to remove the prohibition on FIPs guaranteeing obligations and assuming joint and several obligations, subject to approval by at least two-thirds of the FIP’s investors. This ability to provide guarantees eliminated a significant constraint on deal-making, including indemnities in M&A transactions.

In June 2014, the government announced a series of tax incentives for capital markets transactions, including exemptions from capital gains taxes for investors in middle market companies.

2.2 Have anti-corruption legislation and/or environmental, social and governance principles affected the approach of private equity investors and/or transaction terms?

As authorities have intensified enforcement of anti-corruption, antitrust, environmental, and other compliance rules, PE and VC investors have responded by heightening due diligence standards, strengthening covenants regarding controls and procedures, and exercising greater oversight.

Due diligence of compliance matters has been expanded. Interviews with officers and third parties have become more common and, for certain sectors, routine.

Representations and warranties and covenants dealing with anti-corruption, anti-bribery and other compliance matters have also become increasingly common in deals involving PE and VC investors. Also having an impact is a new Brazilian anti-corruption law that entered into force in January 2014. Oversight is exercised through the board of directors, and it is now standard practice to adopt codes of ethics enunciating rules relating to bribes, third party agents, gifts, conflicts of interest, and creating channels for anonymous complaints. Although not yet a trend, some PE and VC investors have initiated programmes tailored specifically to create a culture of corporate social responsibility and environmental awareness in portfolio companies.

2.3 Could a private equity sponsor (and/or its directors, officers or employees) be exposed to liability for a portfolio company’s actions or omissions in your jurisdiction and if so, on what legal grounds?

Generally, PE and VC sponsors and their employees are not responsible for the liabilities of their portfolio companies. The prominent potential exceptions are environmental and labour obligations. As to environmental liabilities, shareholders and managers are exposed to liability, together with the operating company. Labour courts often allow claimants to seek to recover from shareholders and managers, in an attempt to compel satisfaction of labour obligations. Managers may also be liable for their unlawful actions resulting in tax non-compliance.

Section 3 – FUND FORMATION AND STRUCTURE

3.1 Please describe the typical legal structure used to establish private equity funds, including the primary securities law considerations in private equity fund formation.

PE funds in Brazil are structured as FIPs. FIPs are closed-end investment funds that are allowed to invest in shares, convertible securities and warrants issued by Brazilian corporations (sociedade por ações), provided that such investment allows the FIP a role in the decision-making of the investees.

FIPs are the only type of investment fund in Brazil that is allowed to invest in the equity of unlisted companies.

FIPs must be registered with the CVM, are subject to the oversight of the CVM and have periodic reporting requirements. Registration is typically automatically granted upon the filing of certain documents with the CVM.
Issuances of quotas of FIPs are generally considered public offerings of securities. Accordingly, the requirements for registration of such offerings mirror the general registration requirements for public offerings of other types of securities. The offering registration requirement is waived as to offerings of FIPs that receive investments from 20 or fewer investors. Registration of the FIP itself, however, is always required.

3.2 How are carried interest arrangements typically structured and is there a prevailing methodology for calculating the sponsor’s carried interest?
Sponsors are engaged as managers of the FIPs and are entitled to receive management and performance fees. Management fees generally correspond to a percentage of the commitments of the investors (during the investment period) or the net equity of the FIP (during the holding and divestment periods). Performance fees are typically due and paid only after total distributions to investors exceed the amount invested adjusted by inflation, plus a hurdle rate. Rules relating to the catch-up of performance fees vary.

3.3 Are fund investors typically subject to claw back or a return of distributions to cover their respective allocations of fund liabilities, such as indemnification payments?
FIPs are organised as joint ownerships of assets, and each quota corresponds to a notional fraction of assets owned by the FIP. FIPs are not formed as legal entities and do not confer limited liability. Under Brazilian law, if the net asset value of the FIP is negative, investors are directly responsible for the FIP’s obligations as a matter of law and will be required to make additional capital contributions to the FIP to meet such obligations. Clawback provisions are generally less detailed as a result of these legal obligations.

Administrators and portfolio managers of FIPs may only be liable for liabilities of the FIP if they have not acted in compliance with the investment policy or applicable laws.

Section 4 – STRUCTURE OF ACQUISITION VEHICLE

4.1 What type of entity is typically used as the acquisition vehicle for private equity investments in your jurisdiction? What are the key factors that determine the choice of entity?
FIPs, Brazilian corporations (sociedades por ações) and limited liability companies (sociedades limitadas) are typically used as acquisition vehicles for PE and VC investments. The choice of entity is driven by multiple factors such as the nature, home jurisdiction tax treatment and number of potential investors. Each option offers a different profile of tax burdens and benefits, as the nature, home jurisdiction tax treatment and number of potential investors exceed the amount invested adjusted by inflation, plus a hurdle rate. Rules relating to the catch-up of performance fees vary.

4.2 Does the structure of the acquisition vehicle vary depending on the nature of the investors in the private equity purchaser’s fund?
Yes. If certain requirements are met, foreign investors are eligible for a tax favourable regime and will prefer FIPs over Brazilian corporations or limited liability companies.

Brazilian investors may prefer a FIP because gains realised by a FIP are not taxable until distributed to investors. Generally, Brazilian legal entities avoid FIPs due to the higher costs and lesser tax benefits.

Brazilian pension funds are only allowed to make PE and VC investments through FIPs.

Certain international investors may prefer to use limited liability companies to enjoy pass-through treatment in their home jurisdictions.

4.3 Describe how the choice of acquisition vehicle affects the nature of the incentive equity compensation that can be offered to management.
Although workable incentive equity compensation may be structured for FIPs, corporations and limited liability companies, it is generally easier to do so with respect to corporations. These arrangements are usually structured as stock option or stock grant plans at the portfolio company to offer greater liquidity in the event of an IPO or private sale.

Section 5 – ACQUISITION STRUCTURE

5.1 What are the typical structures used by private equity sponsors to acquire portfolio companies in your jurisdiction? What are the major considerations that govern this decision?
The majority of PE and VC deals are structured as straightforward secondary purchases of existing shares of a corporation, subject to antitrust and regulatory approvals. Capital injections in closely held corporations are also common.

More complex transactions structures will be adopted in: (i) venture capital deals; (ii) mezzanine or similar transactions; (iii) distressed assets; (iv) highly regulated sectors; and (v) investments in listed companies.

Venture capital deals use tiered classes of preferred shares with various liquidation preferences and participation features. Mezzanine transactions may use convertible debentures or redeemable preferred shares. Distressed targets may require the use of convertible debt to secure seniority in a bankruptcy. Regulated companies may issue debentures affording limited governance rights prior to regulatory approval. Listed companies must make a rights offering to issue shares to a PE or VC investor, and will enlist major shareholders to assign preemptive rights to the such investor.

5.2 What are the major issues that drive deal timing in your jurisdiction, including disclosure obligations, financing and regulatory approval requirements?
Timing issues in PE and VC investments in private companies usually relate to the setting up of the investment structure and any antitrust and regulatory approval. Due diligence may be a key issue in growing or family-owned target companies, which may not have well-designed controls in place. If antitrust concerns are expected, the scope and procedure of due diligence may require careful handling.

Occasionally, PE and VC investors may require private companies to remedy outstanding issues as a condition to signing or closing, including paying outstanding taxes, or settling major disputes.

Timing issues are somewhat different for deals involving public companies. Disclosure may be required while negotiations are pending if information leaks and, as a result, a premium will be placed on confidentiality and speed. Due diligence may be more limited, even while the ability to secure adequate indemnities may be constrained. A purchaser of control over a listed company will be required to conduct a mandatory tender offer for shares of minority shareholders, which will prolong the financial exposure of the purchaser.
Section 6 – GOVERNANCE

6.1 Are there any legal requirements in your jurisdiction that would prevent or otherwise affect the ability of a private equity acquirer to designate members of the board and/or management of its portfolio companies? Are there any legal risks for the private equity acquirer in designating such members?

Generally, no legal requirement will prevent a PE or VC investor from designating board members or officers. Legal risks to the PE or VC investor are generally perceived to be remote. In appropriate cases, the investor may consider precautions to avoid allegations of usurping corporate opportunities (if the investor is active in the same sector), insider trading (if the investor is trading shares in public markets) and labour liabilities (see 2.3). In practice, these considerations do not deter PE and VC investors from designating board members in Brazil.

6.2 Are veto rights over major corporate actions (such as dissolution and winding up, merger or consolidation, significant acquisitions or dispositions, incurrence of material indebtedness, or changing the business of the company) typical rights held by private equity acquirers? Are there any limitations or prohibitions on such rights?

PE and VC investors often obtain veto rights in major decisions, which will usually be documented in a shareholders’ agreement.

There are no generally applicable statutory limitations on these rights, but controlling shareholders have fiduciary duties to the corporation that may constrain decision-making in certain extreme circumstances (such as insolvency and compliance issues).

The extent of veto rights will determine whether a shareholder is a controlling person, which may give rise to regulatory consequences and additional obligations for the shareholder. For example, controlling shareholders of financial institutions have broad liability in the case of insolvency. Controlling shareholders of listed companies must arrange for purchasers to tender for all shares held by public investors.

6.3 Do private equity funds or any board members they appoint have any fiduciary or other duties to minority equity-holders or other stakeholders of a portfolio company? Are there any prohibitions against acquisitions of, or investments in, competing or complimentary businesses?

Brazilian corporate law provides for fiduciary duties for board members and officers, including duties of care, loyalty, confidentiality and disclosure. Unless expressly permitted to do so by the shareholders, board members and officers may not act for competing companies.

Fiduciary duties extend to a controlling shareholder, but do not prevent investment in competing businesses. In these cases, board members and officers must not be contaminated by the conflicts of interest of the PE or VC investors that designated them. Conversely, board members and officers must take care when communicating with a PE or VC investor.

Section 7 – DEAL TERMS

7.1 What pricing structures are typically preferred by private equity sponsors in your jurisdiction?

Pricing structures may vary significantly. Price adjustments for working capital and net debt variations are common in PE and VC deals in Brazil. Earn-out provisions are often deployed to overcome pricing gaps.

Escrows, holdbacks and seller financing may help limit exposure to contingent liabilities.

7.2 What is the typical scope of the representations and/or warranties, covenants, undertakings and indemnities provided by a private equity seller and the target company’s management team to an acquirer in an acquisition agreement?

PE and VC investors will seek to offer representations, warranties, covenants and indemnities that are narrower in scope and shorter in duration than the analogous provisions offered by family owners, entrepreneurs or strategic investors. PE and VC investors will want to have offsets against protections from the sellers from which they purchased their interests. Non-compete and non-solicitation obligations of a PE or VC investor, if any, will tend to be narrower.

The representations and warranties of the target company and its management are relevant only to the extent that they establish liability for the PE or VC investors in the sale of a closely held company. A listed company will be reluctant to offer expansive representations and warranties to PE and VC investors.

7.3 What are the customary time limits and other limitations on liability applicable to representations and/or warranties given by a private equity seller and the target company’s management team?

Time limits vary widely, but typical contractual limitations are two to four years for claims relating to labour matters, three to six years for claims relating to tax matters and the statutory limitations period for claims relating to fundamental matters. PE and VC sellers may seek to limit their exposure further, and deals have been struck in which all indemnities expired within six months of closing.

Caps, baskets and thresholds for indemnification payments are also commonly set for PE and VC transactions. Members of the management team usually do not agree to indemnification obligations, unless they are also selling shareholders.

7.4 What methods are typically used to fill any ‘warranty gap’ in your jurisdiction? Is warranty and indemnity insurance commonly used in private equity transactions in your jurisdiction?

A warranty gap (meaning a period during which pre-closing claims may be brought against a target company but no indemnities or other protections are available from sellers) will be difficult to address if the contracting parties have not made a specific provision in the agreements. A buyer may deduct from the purchase price an amount for projected unindemnifiable losses. Buyers may also seek to ascertain and address contingent liabilities shortly upon acquiring a target, in order to precipitate a resolution of indemnifiable claims, to the extent consistent with their contractual obligations to minimise losses.

Indemnity insurance is not commonly used in Brazilian deals.

7.5 What conditions to a private equity sponsor’s obligation to complete an acquisition are typically included in the acquisition agreement? Are these conditions usually substantially aligned with the conditions included in the financing documentation?

Typical conditions precedent may include third party consents, and antitrust and other governmental approvals. In the rare instances in which third party financing is made available, the conditions set out in the financing documents will include a reference to the satisfaction of the conditions precedent set forth in the acquisition documents.
7.6 To what extent are purchaser funds at risk for the equity capital committed to a transaction? Are third-party beneficiary rights or other enforcement rights typically made available to the seller?

Investment agreements typically constitute a binding commitment on the purchaser, subject only to conditions precedent relating to third-party approvals. The issue of third-party beneficiary rights for the seller accordingly does not arise. Transactions involving a concurrent debt financing are still the exception, and, in those cases, a financing condition (permitting the purchaser not to close if financing were withheld) would still be unusual.

7.7 How is a management team’s equity participation typically structured, including customary types of equity interest, percentage holding of equity and approximate level of investment?

Management equity participation is granted by means of a stock option or stock grant plan, providing for vesting, forfeiture and lock-ups. Shares covered by such plans usually represent no more than 10% of total shares.

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United States

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Section 1 – PRIVATE EQUITY LANDSCAPE

1.1 How would you describe the current state of private equity activity in your jurisdiction, including the most common forms of private equity transactions?

Record levels of capital available for investment and historically low interest rates for acquisition financing should produce an upsurge in private equity (PE) activity. However, buyers are struggling to find quality assets at attractive prices as a result of competition for assets and a need for stricter discipline in purchase price multiples.

PE buyers therefore continue to engage in add-on acquisitions, with a focus on enhancing the value of existing portfolio companies. Low interest rates and accessible debt markets have also facilitated leveraged recapitalisations. Although PE sellers appear to be well positioned for portfolio company sales, the resurgence of acquisition activity continues to be challenged.

1.2 Are there any factors that make your jurisdiction attractive to private equity investment at this time or that will spur private equity investment in the near term?

Due to continuing economic uncertainty and volatility in other markets, US targets remain attractive to buyers seeking to take advantage of low interest rates and the perceived safety of investing in the US. Financial sponsors continue to sit on large capital reserves earmarked for acquisition-related investment.

Section 2 – SIGNIFICANT LEGAL DEVELOPMENTS

2.1 Have there been any recent regulatory developments, including tax developments, in your jurisdiction affecting the raising, formation, governing terms or operation of private equity investment funds or investments made by funds?

There is continued debate over matters ranging from information disclosure to carried interest taxation of US funds. The Dodd Frank Act has been a principal development, requiring US PE fund managers to register as investment advisors with state or federal authorities. The Consumer Finance Protection Bureau has, in some cases, targeted portfolio companies in connection with violations. The US Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) for violations of the Foreign Corrupt Practices Act (FCPA). In rare instances, claims of veil-piercing can be made to lift the limited liability shield. Other regimes, such as those imposing liability for pension obligations and trust fund taxes, can expose general partners to vicarious liability. A 2013 US First Circuit Court of Appeals case, Sun Capital Partners III v New England Teamsters and Trucking Industry Pension Fund, held that under certain circumstances, a US fund or its other portfolio companies may be liable for the unfunded pension obligations of one of the fund’s portfolio companies. While the decision is not binding on courts in other US federal circuits, it underscores one type of risk funds may face in the US.

2.2 Have anti-corruption legislation and/or environmental, social and governance principles affected the approach of private equity investors and/or transaction terms?

PE funds have received increased focus from the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) for violations of the Foreign Corrupt Practices Act (FCPA). PE funds must be sensitive to FCPA-compliance in fundraising, where relationships between sponsors and sovereign wealth funds have become the subject of government scrutiny, and acquisitions, where FCPA-compliance in due diligence can be critical to preserving investment value and avoiding enforcement actions against targets and their sponsors.

Environmental and socially responsible investment funds have increased in number. In one extreme case, the institutional investors of a major US PE fund forced the fund to seek a sale of a portfolio company that manufactured assault weapons.

2.3 Could a private equity sponsor (and/or its directors, officers or employees) be exposed to liability for a portfolio company’s actions or omissions in your jurisdiction and if so, on what legal grounds?

Limited partnerships used in the US as fund vehicles place clear limitations on the liability of limited partners for actions of the partnership and its portfolio investments. In rare instances, claims of veil-piercing can be made to lift the limited liability shield. Other regimes, such as those imposing liability for pension obligations and trust fund taxes, can expose general partners to vicarious liability. A 2013 US First Circuit Court of Appeals case, Sun Capital Partners III v New England Teamsters and Trucking Industry Pension Fund, held that under certain circumstances, a US fund or its other portfolio companies may be liable for the unfunded pension obligations of one of the fund’s portfolio companies. While the decision is not binding on courts in other US federal circuits, it underscores one type of risk funds may face in the US.

Section 3 – FUND FORMATION AND STRUCTURE

3.1 Please describe the typical legal structure used to establish private equity funds, including the primary securities law considerations in private equity fund formation.

In the US, legal entities are created under state (rather than federal) laws. Delaware is the most common state in which to form an entity because it has a developed body of corporate and alternative entity (such as limited partnership and limited liability company) law, sophisticated courts, and an efficient administrative framework facilitating corporate activities.

Funds typically raise capital from institutional investors and sophisticated third parties, who acquire limited partnership interests in the fund. To comply with US securities laws, funds are generally raised through private placements to prospective investors that satisfy sophistication standards. Private placements typically involve a disclosure document (private placement memorandum) that contains disclosure information regarding the fund, its structure and related economics, the PE fund sponsor, the fund’s investment objectives, and other information material to investors’ decisions.

3.2 How are carried interest arrangements typically structured and is there a prevailing methodology for calculating the sponsor’s carried interest?

The PE sponsor’s carried interest entitles it to receive a specified percentage – typically 20% – of the upside on the fund’s investments after the fund returns invested capital plus a preferred return to limited partners. Preferred return or hurdle requirements are calculated to achieve an internal rate of return on invested capital before the carried interest kicks in. Carried interest can be structured on a deal-by-deal or whole-fund basis; deal-by-deal arrangements pay the sponsor a return on successful deals, without reference to whether other fund investments, or the fund as a whole, are profitable.

3.3 Are fund investors typically subject to claw back or a return of distributions to cover their respective allocations of fund liabilities, such as indemnification payments?

US funds typically include clawback rights that require investors to return a portion of distributions to cover fund liabilities (such as indemnification payments). Clawback obligations are generally subject to caps and time limitations.
Section 4 – STRUCTURE OF ACQUISITION VEHICLE

4.1 What type of entity is typically used as the acquisition vehicle for private equity investments in your jurisdiction? What are the key factors that determine the choice of entity?

Funds typically create limited liability companies (LLCs) or corporations to serve as the acquisition vehicle for investments (see 3.1). The key factor in deciding entity form is tax treatment; corporations are subject to income tax and LLCs are generally pass-through or disregarded entities from a tax perspective.

Considerations for choosing an acquisition vehicle structure tend to be based on the target’s structure, desired tax treatment and nature of the investors.

4.2 Does the structure of the acquisition vehicle vary depending on the nature of the investors in the private equity purchaser’s fund?

Certain tax-exempt investors may require a corporate or other taxable entity to act as a blocker between the investor and the acquired portfolio company so the investor can avoid UBTI – unrelated business taxable income. The fund may use a corporation as its acquisition vehicle or allow tax-exempt investors to participate through an alternative investment vehicle. Numerous considerations come into play when contemplating alternative investment vehicle structures, because of the disparate tax treatment of interests held by investors who come into the investment through a blocker versus those who come in directly through a pass-through structure.

4.3 Describe how the choice of acquisition vehicle affects the nature of the incentive equity compensation that can be offered to management.

One advantage of using an LLC as an acquisition vehicle is that it allows the fund to grant the management team incentive equity compensation in the form of profits interests – a share of the appreciation of the company’s value after the grant date. The profits interest recipient becomes an immediate member (equity holder) of the LLC and may receive beneficial tax treatment. Additionally, profits interests from LLCs and other alternative entities can be designed with a wide range of features, making them particularly attractive as incentive and retention tools.

Corporations use stock options, restricted stock awards or similar equity-based or linked compensation, which can be structured to have largely the same economic benefits as profits interests, but generally do not receive the same beneficial tax treatment.

Section 5 – ACQUISITION STRUCTURE

5.1 What are the typical structures used by private equity sponsors to acquire portfolio companies in your jurisdiction? What are the major considerations that govern this decision?

Private company acquisitions are typically structured as mergers, equity sales or asset sales. Public companies are typically acquired by merger or tender offer. Given the relatively larger and more disparate base of public company stockholders, structures providing for collective action – such as mergers and tender offers – are typically more viable.

5.2 What are the major issues that drive deal timing in your jurisdiction, including disclosure obligations financing and regulatory approval requirements?

Most US PE transactions involve a delay between the signing of a definitive acquisition agreement and acquisition closing.

The Hart-Scott-Rodino (HSR) Act requires that parties in certain size transactions file a notification with the Federal Trade Commission and DOJ. Transactions involving international operations may require additional notifications and approvals based on the applicable jurisdiction’s competition laws.

If the target is a public company, or if publicly-traded securities will be used either as consideration in the transaction or for financing, then the transaction will require the preparation of a proxy statement or prospectus that may be subject to review by the SEC.

Additional approvals may be required if the target operates in a regulated industry, such as insurance, telecommunications or energy.

As PE-sponsored transactions typically involve leveraged debt financing, there is generally a period between the date the acquisition agreement is signed and the completion of the financing and receipt of funds on the closing date.

Section 6 – GOVERNANCE

6.1 Are there any legal requirements in your jurisdiction that would prevent or otherwise affect the ability of a private equity acquirer to designate members of the board and/or management of its portfolio companies? Are there any legal risks for the private equity acquirer in designating such members?

There are generally no restrictions on the acquirer’s ability to designate members of the board and management of portfolio companies (see 6.3). Having at least some independent directors on the board is desirable, as the presence of majority board control by the sponsor can lead to questions regarding the process undertaken in approving insider transactions.

6.2 Are veto rights over major corporate actions (such as dissolution and winding up, merger or consolidation, significant acquisitions or dispositions, incurrence of material indebtedness, or changing the business of the company) typical rights held by private equity acquirers? Are there any limitations or prohibitions on such rights?

PE acquirers hold veto rights over major corporate actions, either expressly through negotiated LLC or stockholders agreements, or through de facto control of the board of directors or managers. As control investors, PE sponsors have control over these issues by virtue of stock ownership and related voting rights, and through board representation. In cases involving a significant minority co-investor, these rights may be given to protect the interests of the minority holder.

6.3 Do private equity funds or any board members they appoint, have any fiduciary or other duties to minority equity-holders or other stakeholders of a portfolio company? Eg are there any prohibitions against acquisitions of, or investments in, competing or complimentary businesses?

The default provisions of Delaware law generally impose fiduciary duties on controlling equity holders and board members to act in the best interests of the portfolio company and its stockholders. However, Delaware law favours freedom of contract in the case of LLCs and other alternative entities, therefore permitting fiduciary duties and corporate opportunities to be expressly disclaimed in LLC agreements. A controlling stockholder of a corporation such as a PE sponsor may also owe duties directly to the minority holders, so care must be taken when taking action that affects the interests of the minority. This is particularly true where an interested transaction is being considered.

Section 7 – DEAL TERMS

7.1 What pricing structures are typically preferred by private equity sponsors in your jurisdiction?

Although a purchase price may be negotiated based on a multiple of EBITDA (earnings before interest, taxes, depreciation, and amortisation) or other financial metrics, the base price in a definitive acquisition agreement is typically expressed as a fixed dollar amount (subject to adjustment based on the target’s indebtedness, cash, working capital and transaction expenses). Price adjustments are typically estimated for purposes of payment at closing and subject to a true-up procedure. Earn-outs and other contingent post-
closing payments based upon the target’s performance are also sometimes used.

7.2 What is the typical scope of the representations and/or warranties, covenants, undertakings and indemnities provided by a private equity seller and the target company’s management team to an acquirer in an acquisition agreement?

PE sellers seek certainty with respect to their obligations and seek to limit the scope of the representations and their exposure for indemnification based upon strict caps and time limitations.

Target company management teams are not typically asked to make representations or undertakings in their personal capacity (separate from their proportionate interest in the sale proceeds) but may be asked to agree to non-competition restrictions or their employment terms post-acquisition.

7.3 What are the customary time limits and other limitations on liability applicable to representations and/or warranties given by a private equity seller and the target company’s management team?

Liability limitations are negotiated deal to deal depending on the transaction. Competitive sale processes can result in little or no post-closing exposure for the seller. However, if significant contingencies are identified, the resulting post-closing obligations may be significant and subject to softer limitations. Frequently, representations and warranties survive for 12 to 18 months post-closing and are subject to a deductible or basket of 0.5% to 1% of the purchase price. Caps vary, but in sponsor sales are typically less than 10% of the purchase price.

7.4 What methods are typically used to fill any ‘warranty gap’ in your jurisdiction? Is warranty and indemnity insurance commonly used in private equity transactions in your jurisdiction?

The use of warranty and indemnity insurance in PE transactions is increasing in popularity and is expected to become more standard, but is still not widespread. Increasingly, insurers are able to make these policies available on a timely and cost-effective basis.

7.5 What conditions to a private equity sponsor’s obligation to complete an acquisition are typically included in the acquisition agreement? Are these conditions usually substantially aligned with the conditions included in the financing documentation?

Acquisition completion conditions typically include the accuracy of representations and warranties (subject to material adverse effect or materiality tests), performance of pre-closing covenants and absence of any material adverse effect on the target company.

Financing conditions are resisted by sellers, making it critically important for the acquirer to ensure that conditions to closing the acquisition are aligned with the conditions to financing.

7.6 To what extent are purchaser funds at risk for the equity capital committed to a transaction? Are third-party beneficiary rights or other enforcement rights typically made available to the seller?

Sellers require funds to deliver an equity commitment letter which, together with the debt commitment letters delivered by lenders, provides an aggregate commitment sufficient to complete the transaction. Third-party beneficiary rights and other enforcement rights are frequently included in equity commitment letters for a seller’s benefit. Parties will negotiate to determine the extent to which a sponsor can be forced to fund its commitment in circumstances where a deal will not close.

7.7 How is a management team’s equity participation typically structured, including customary types of equity interest, percentage holding of equity and approximate level of investment?

Management teams may be asked to roll over portions of their target company equity into the acquired company in order to incentivise their focus on business growth. The acquirer will generally create a new equity pool for grants to management and new members of the management team. The percentage held by or awarded to management will differ across transactions. Typically, a new equity plan of 10% of the outstanding equity will be put in place at closing. Roll-over percentages vary, but can be 30% or more.

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SECTION 1 – PRIVATE EQUITY LANDSCAPE

1.1 How would you describe the current state of private equity activity in your jurisdiction, including the most common forms of private equity transactions?

Private equity (PE) activity in China has for several years steadily increased. The most common form of PE investment is the direct acquisition of a stake in the target company.

1.2 Are there any factors that make your jurisdiction attractive to private equity investment at this time or that will spur private equity investment in the near term?

Continued economic growth and the gradual development of a consumption-based economy are significant factors driving PE investment in China. In addition, the growing pool of private money in China is contributing to growth in the domestic PE environment, which offers greater returns than those typically available through other more traditional forms of investment. Moreover, the regulatory environment for PE activities in recent years has continued to mature. All of these trends are expected to continue, and together they should stimulate additional PE investment.

Section 2 – SIGNIFICANT LEGAL DEVELOPMENTS

2.1 Have there been any recent regulatory developments, including tax developments, in your jurisdiction affecting the raising, formation, governing terms or operation of private equity investment funds or investments made by funds?

Recent deregulation on both inbound and outbound investments and streamlined foreign exchange controls are likely to facilitate more investment by PE funds and industrial investors. These trends are expected to lead to additional developments.

2.2 Have anti-corruption legislation and/or environmental, social and governance principles affected the approach of private equity investors and/or transaction terms?

Compliance concerns, including anti-corruption and anti-bribery, employment law, anti-competition, worker health and safety, social welfare, environmental and supply chain integrity concerns, continue to be a significant factor in the evaluation of any target company.

Recent regulatory developments and heightened enforcement across a range of compliance matters have brought these concerns into sharp focus. The main effect on transactions involves the scope of pre-acquisition due diligence, including due diligence covering relevant third parties. Transaction structure can also be affected, particularly if structural changes are needed to address compliance concerns identified during pre-acquisition due diligence.

In addition, compliance matters are typically of primary concern in formulating and executing a post-acquisition integration programme that identifies gaps and enhances awareness, training and compliance-related supervision, audit rights and internal controls.

2.3 Could a private equity sponsor (and/or its directors, officers or employees) be exposed to liability for a portfolio company’s actions or omissions in your jurisdiction and if so, on what legal grounds?

In circumstances involving an alleged violation of law or the failure to comply with the requirements of the company’s constitutional documents, the statutory legal representative of the company may be held personally liable. In addition, persons responsible for the particular act or omission may also be held personally liable. We are not aware of any case in which direct liability has been imposed on a shareholder. That said, there are legal bases for doing so, if the acts or omissions are related to a breach of the duties owed to the company, including a failure to adequately supervise or train persons appointed by the shareholder as directors or management, or if the shareholder has acted in a manner that would permit piercing the corporate veil and imposing direct liability on the shareholder for the acts of the portfolio company.

Section 3 – FUND FORMATION AND STRUCTURE

3.1 Please describe the typical legal structure used to establish private equity funds, including the primary securities law considerations in private equity fund formation.

Similar to other jurisdictions, PE funds in China typically take the form of a limited partnership. The primary securities law considerations in PE fund formation include not conducting a public offering of the fund units or partnership interests, and limitations on the number of partners (not to exceed 50) and the number of investors (not to exceed 200). Moreover, according to the rules of Assets Management Association of China (AMAC), investors in PE funds registered with the AMAC must be qualified investors.

3.2 How are carried interest arrangements typically structured and is there a prevailing methodology for calculating a sponsor’s carried interest?

Carried interest arrangements are similar to those commonly seen in offshore PE funds. The carried interest is typically calculated and distributed on a deal by deal basis, subject to a carry escrow account and claw back requirements.

3.3 Are fund investors typically subject to claw back or a return of distributions to cover their respective allocations of fund liabilities, such as indemnification payments?

Although there are funds in which investors are subject to claw back or a return of distributions to cover their share of fund liabilities, this is not typical.

Section 4 – STRUCTURE OF ACQUISITION VEHICLE

4.1 What type of entity is typically used as the acquisition vehicle for private equity investments in your jurisdiction? What are the key factors that determine the choice of entity?

The type of entity will depend on the underlying transaction. In cases involving acquisitions through an entity organised outside of China, it is not unusual to use a special purpose vehicle for the transaction. In some cases, the acquisition vehicle may also be the fund entity itself. For domestic acquisitions, it is more common to use the fund entity as the acquisition vehicle.
4.2 Does the structure of the acquisition vehicle vary depending on
the nature of the investors in the private equity purchaser’s fund?
Yes, as noted above, the choice of acquisition vehicle will depend to some
extent on whether the transaction involves a direct investment from a non-
Chinese source.

4.3 Describe how the choice of acquisition vehicle affects the
nature of the incentive equity compensation that can be offered to
management.
Here again, there is a distinction between the use of an acquisition vehicle
organised in a jurisdiction outside of China and one organised in China.
There are a number of mechanisms available to structure equity compensa-
tion in many jurisdictions outside of China which are not yet fully devel-
oped under Chinese corporate law. See section 7.7.

Section 5 – ACQUISITION STRUCTURE

5.1 What are the typical structures used by private equity sponsors
to acquire portfolio companies in your jurisdiction? What are the
major considerations that govern this decision?
The structures vary across sectors and the nature of the target. Among the
major considerations are whether the target is publicly traded or privately
held, whether the transaction involves state assets and accordingly requires
additional approvals, whether foreign investment in the business of the tar-
get is permitted, restricted or prohibited, and other factors. Structures typi-
cally seen include equity acquisitions, asset deals, privately placed shares
and in some cases, pre-acquisition restructurings followed by an equity ac-
quisition of the restructured business.

5.2 What are the major issues that drive deal timing in your
jurisdiction, including disclosure obligations, financing and
regulatory approval requirements?
The major gating issues typically revolve around regulatory approval require-
ments. Although recent developments have streamlined certain types of ap-
provals, including approvals from the National Development and Reform
Commission and the Ministry of Commerce, the overall process can be a
lengthy one. If other approvals are required, either because the target is pub-
licly traded, or the transaction involves state assets or a highly regulated busi-
ness, the types of approvals required will increase and so timing will also
likely be affected.

Section 6 – GOVERNANCE

6.1 Are there any legal requirements in your jurisdiction that would
prevent or otherwise affect the ability of a private equity acquirer to
designate members of the board and/or management of its portfolio
companies? Are there any legal risks for the private equity acquirer
in designating such members?
For certain types of entities, there is a requirement that board appointments
be proportional to equity holdings. This requirement does not apply to man-
agement appointments. In addition, if the appointee for a management po-
position is not a Chinese national, generally applicable visa requirements would
apply.

In certain circumstances, the acquirer could be found vicariously liable for
an appointee’s action or failure to act. The acquirer has a duty to select ap-
propriate appointees, and a general duty to see that each appointee under-
stands his or her duties, and acts in compliance with law and the articles of
association of the portfolio company.

6.2 Are veto rights over major corporate actions (such as
dissolution and winding up, merger or consolidation, significant
acquisitions or dispositions, incurrence of material indebtedness,
or changing the business of the company) typical rights held by
private equity acquirers? Are there any limitations or prohibitions
on such rights?
Yes, veto rights on specific board decisions are often granted to PE acquirers.
In certain cases, the law provides an effective veto right on enumerated de-
cisions which require the agreement of all members of the board. There are
no express limitations or prohibitions on veto right per se, but the exercise
of veto rights, like other board actions, is subject to each director’s general
duty of loyalty, due care and good faith.

6.3 Do private equity funds or any board members they appoint,
have any fiduciary or other duties to minority equity-holders or
other stakeholders of a portfolio company? Eg are there any
prohibitions against acquisitions of, or investments in, competing
or complimentary businesses?
Directors owe a duty of loyalty, due care and good faith to the company on
whose board they serve. There are also express prohibitions covering acts re-
lated to bribery, conversion of company assets or funds, abuse of position
and power and breaches of confidentiality. There is also a blanket prohibi-
tion of any other act which violates a director’s duty of loyalty to the com-
pany. These general duties and prohibitions may in specific circumstances
act to prohibit an acquisition of, or an investment in, a competing or com-
plimentary business.

Section 7 – DEAL TERMS

7.1 What pricing structures are typically preferred by private equity
sponsors in your jurisdiction?
Pricing structures vary widely among PE investors. Pricing for transactions
involving state assets is regulated, and must be based on the value appraised
by a qualified appraisal firm. Pricing for acquisitions of publicly traded com-
panies is separately regulated. An earn-out or ratchet mechanism is not un-
common in PE investment deals, although these arrangements are difficult
to structure for inbound transactions involving foreign investment in a Chi-
nese company.

7.2 What is the typical scope of the representations and/or
warranties, covenants, undertakings and indemnities provided by a
private equity seller and the target company’s management team to
an acquirer in an acquisition agreement?
Representations, warranties, covenants, undertakings and indemnities are
typically provided by the company and the controlling shareholder, and only
in unusual circumstances would management or a minority PE seller step
up to cover specific matters.

7.3 What are the customary time limits and other limitations on
liability applicable to representations and/or warranties given by a
private equity seller and the target company’s management team?
Market practice varies from transaction to transaction. However, certain
types of representations and warranties are usually stated to survive for a ne-
gotiated period beyond the closing.

7.4 What methods are typically used to fill any ‘warranty gap’ in
your jurisdiction? Is warranty and indemnity insurance commonly
used in private equity transactions in your jurisdiction?
Warranty and indemnity insurance are not commonly used, although they
are now being offered. We expect the use of warranty and indemnity insur-
ance to increase as the market becomes more familiar with coverage and
pricing.
7.5 What conditions to a private equity sponsor’s obligation to complete an acquisition are typically included in the acquisition agreement? Are these conditions usually substantially aligned with the conditions included in the financing documentation?

The acquisition agreement typically includes the full range of closing conditions that would be expected in any other jurisdiction, plus additional conditions that relate to governmental approvals, filings and registrations. In well-documented transactions, the closing conditions in the acquisition agreement are substantially aligned with the conditions set out in the financing documentation. There may be some areas of difference, however, particularly if there are specific financial covenants that apply to the financing but are not directly relevant to the acquisition.

7.6 To what extent are purchaser funds at risk for the equity capital committed to a transaction? Are third-party beneficiary rights or other enforcement rights typically made available to the seller?

A purchaser is obligated under law to make timely payment of capital subscribed by it. In addition, a purchaser will be bound under the transaction documentation to make agreed payments as required by the relevant transaction documentation. There is no third-party beneficiary doctrine. The general approach is based on a strict requirement of privity of contract. The seller would have rights and remedies set out in the relevant transaction documents. These would typically include the right to seek enforcement or specific performance. However, that contractual right will be limited if the parties have agreed to mediation, arbitration or a combination of the two as the exclusive method for dispute resolution. In addition, the courts are not likely to order specific performance through the issuance of a positive injunction. The more typical court remedy would be an award of damages for breach of contract, which can include elements in addition to the purchase price alone.

7.7 How is a management team’s equity participation typically structured, including customary types of equity interest, percentage holding of equity and approximate level of investment?

There are a variety of structures, and the structure of management equity participation differs depending on whether the target is or will become a foreign-invested entity or a Chinese domestic entity. The types of equity participation also vary widely, from direct equity ownership to shadow equity participation in the form of bonus payments calculated by reference to share price or other financial indicators. The percentage and level of management participation also vary, and will be driven by the goals of the investor, management and the founder or founders. In addition, there are restrictions and registration requirements relating to the holding of equity by Chinese beneficiaries in special purpose vehicles and other entities organised outside of China. Finally, it is also possible to structure equity and equity-like performance awards through the use of an affiliate of the acquirer that is publicly traded on a recognised exchange outside of China, subject to advance registration with the State Administration for Foreign Exchange, withholding tax obligations and continuing reporting requirements.

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It has been 10 years since the introduction of private equity funds (PEFs) in Korea. During this period, the private equity (PE) market has rapidly expanded, both in size and importance. As of the end of 2013, registered domestic PEFs numbered 237 and the total capital commitments reached W44 trillion ($43 billion). Further, in today’s depressed M&A market, where large corporations are reluctant to engage in deals due to risk concerns, PEFs have become integral players in driving deal volume, and their importance is underscored by their being party to virtually all the big M&A deals in recent times. In this and in other ways, the tenth anniversary of the introduction of PEFs in Korea represents an important marker in their evolution. It is only now that the liquidation of the first wave of Korean PEFs, which generally have a 10-year term, is taking place and offering a means of exit for investors. Equally significant, and a sure sign of the PE market’s maturation in Korea, is that as a result of the liquidation of the first Korean PEFs established in 2004, the PE firms that have served as general partners (GPs) are now being assessed according to their performance in the market.

When the PEF scheme was introduced in Korea in 2004, the Korean government laid out a plan to develop Korean PEFs in three phases. They were to be tailored to the circumstances in Korea and distinguished from their global counterparts. The first phase would separate PEFs from general private funds in a two-track system and regulate PEFs with the government’s right to intervention. The second phase would relax the regulations on PEFs while maintaining the two-track system. The third and final phase would do away with the two-track system and regulate PEFs and general private funds in the same manner, removing any special regulations. In 2013, the Korean government proposed amendments to the Financial Investment Services and Capital Markets Act (FSCMA), which included changes to the existing PEF scheme. Although the proposed amendments to the FSCMA mainly relate to the revitalisation of the M&A market in response to the economic recession after the global financial crisis in 2008, the proposed changes to the PEF scheme can be seen as heralding the second phase of the Korean government’s developmental plan for Korean PEFs. The proposed amendments to the FSCMA relating to PEFs can be separated into three major categories. The first is the replacement of the existing registration requirements with a mere reporting requirement. This is a major change that facilitates the process of establishing PEFs, and should the proposed amendments be approved by the National Assembly, it is anticipated that the government regulation of PEFs would ease significantly. The second relates to the increased regulation of PE firms acting as GPs, due to the need for sup

A sure sign of the PE market’s maturation is that as a result of the liquidation of the first Korean PEFs, firms that have served as GPs are now being assessed according to their performance in the market.

Haeng-Gyu Lee and Hee-Suk Chai of Jipyong examine proposed amendments to legislation, which herald the second phase of the Korean government’s plan for PEFs.
If they are approved by the National Assembly, supplemental legislation will be amended accordingly. Then, Korean PEFs will have clearly entered the second phase of development.
However, there are some minor changes with respect to the management of a PEF’s remaining assets after the buy-out investments. Most significantly, the limitation in securities investment for the purpose of maintaining an investment portfolio is enhanced from 5% to 30% of the total assets of the PEF. Further, investment in derivatives for hedging foreign exchange risk is also permitted by the proposed amendments to the FSCMA.

Meanwhile, the regulations on conflict of interest between PEFs and GPs have been elaborated in the proposed amendments to the FSCMA. Under the existing FSCMA, transactions between PEFs and GPs are permitted with the consent of all the PEF partners, and beyond such rule, the conflict of interest is regulated by the fiduciary duty of GPs. However, in accordance with the proposed amendments to the FSCMA: (i) any transaction between a PEF and GPs (or specially related persons to GPs) is prohibited in principle, except when such transaction takes place on a stock exchange, or when such transaction is clearly favourable to the PEF; (ii) PEFs are prohibited from acquiring securities issued by GPs; and, (iii) the acquisition of securities issued by specially related persons to GPs is permitted only up to a certain limit. Additionally, proposed amendments to the FSCMA stipulate regulations on the participation of specially related persons to GPs as limited partners in a PEF.

Regulation on the use of SPC
As explained earlier, various restrictions are applied with respect to asset management by a PEF. However, PEFs may get around such restrictions by using a special purpose company (SPC). For example, the PEF may invest their entire assets in an SPC, which may in turn use the assets in a manner prohibited for PEFs, such as lending money. As the investment of PEFs in SPCs falls under the category of buy-out investments, the SPC can be misused by the PEF to avoid restrictions on asset management. As a result, the FSCMA stipulates certain requirements for an SPC when used by a PEF, and restrictions on asset management are also applied to the SPC. Further, to ensure the effectiveness of such regulations, PEFs are not permitted to invest in a newly established company, since it is hard to distinguish a newly established company from an SPC.

Regulations on the use of an SPC are maintained under the proposed amendments to the FSCMA, although there have been strong requests from market players to abolish such restrictions. The proposed amendments, however, do relax some restrictions on SPCs. The PEF may: (i) make use of two-level SPCs; and (ii) invest in a newly established company other than the SPC permitted by the FSCMA in order to acquire a business. If approved, the proposed amendments to the FSCMA will have the effect of further stimulating PEFs’ M&A activities.

Next steps for the FSCMA amendments
The process of gathering opinions and feedback from industry professionals and the public on the proposed amendments to the FSCMA has been completed, and they will shortly be sent to the National Assembly for a vote. If they are approved by the National Assembly, supplemental legislation, including the Enforcement Decree of the FSCMA and the Regulations on Financial Investment Business, will be amended accordingly. Then, Korean PEFs will have clearly entered the second phase of development, as planned by the government 10 years ago when it implemented the PEF scheme. The opportunities that the PE market maturation in Korea will bring to investors are keenly awaited.