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The International Comparative Legal Guide to:

Private Equity 2016

2nd Edition

A practical cross-border insight into private equity

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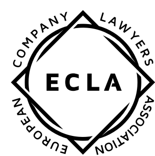

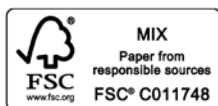

General Chapters:

1	**Know Your Target – Compliance Due Diligence in M&A Transactions** – Dr. Lutz Zimmer & Simon Rootsey, Skadden, Arps, Slate, Meagher & Flom LLP	1
2	**Legal and Commercial Deal Protection Trends in Global Private Equity Transactions** – Stephen Lloyd, Allen & Overy LLP	5
3	**Finding the Right Recipe: An Introduction to Structuring Considerations for Private Equity Co-Investments** – Eleanor Shanks & Kasit Rochanakorn, Dentons UKMEA LLP	10
4	**Enforcing Investors' Rights in Latin America: Some Basic Considerations** – Emilio J. Alvarez-Farré, Greenberg Traurig, LLP	14

Country Question and Answer Chapters:

5	**Angola**	Vieira de Almeida & Associados – Sociedade de Advogados, R.L. and Angola Capital Partners: Hugo Moredo Santos & Rui Madeira	19
6	**Australia**	Atanaskovic Hartnell: Lawson Jepps & Jon Skene	26
7	**Austria**	Schindler Attorneys: Florian Philipp Cvak & Clemens Philipp Schindler	35
8	**Brazil**	Pinheiro Neto Advogados: Eduardo H. Paoliello Jr.	44
9	**Canada**	McMillan LLP: Michael P. Whitcombe & Brett Stewart	51
10	**China**	Zhong Lun Law Firm: Lefan Gong & David Xu (Xu Shiduo)	58
11	**Finland**	Borenius Attorneys Ltd: Johannes Piha & Johan Roman	67
12	**Germany**	Milbank, Tweed, Hadley & McCloy LLP: Dr. Peter Memminger	74
13	**Hungary**	Lovrecz, Mangoff & Temesi: Éva Lovrecz & Peter Mangoff	81
14	**India**	Samvād: Partners: Apurva Jayant & Ashwini Vittalachar	89
15	**Ireland**	Matheson: Éanna Mellett & Aidan Fahy	99
16	**Italy**	Chiomenti Studio Legale: Franco Agopyan & Massimo Antonini	107
17	**Kenya**	Anjarwalla & Khanna: Dominic Rebelo & Roddy McKean	116
18	**Luxembourg**	Stibbe: Claire-Marie Darnand & Diogo Duarte de Oliveira	122
19	**Netherlands**	Houthoff Buruma: Alexander J. Kaarls & Johan W. Kasper	132
20	**Nigeria**	Udo Udoma & Belo-Osagie: Folake Elias-Adebowale & Christine Sijuwade	141
21	**Norway**	Aabø-Evensen & Co: Ole Kristian Aabø-Evensen & Harald Blaauw	147
22	**Portugal**	Morais Leitão, Galvão Teles, Soares da Silva & Associados: Ricardo Andrade Amaro & Pedro Capitão Barbosa	167
23	**Russia**	Baker Botts LLP: Melinda Rishkofski & Iverson Long	174
24	**Singapore**	Allen & Gledhill LLP: Christian Chin & Lee Kee Yeng	182
25	**Spain**	J&A GARRIGUES, S.L.P.: Ferran Escayola & María Fernández-Picazo	189
26	**Sweden**	Hannes Snellman Attorneys Ltd: Claes Kjellberg & Shoan Panahi	197
27	**Switzerland**	Bär & Karrer AG: Dr. Christoph Neeracher & Dr. Luca Jagmetti	205
28	**United Kingdom**	Skadden, Arps, Slate, Meagher & Flom LLP: Simon Rootsey	212
29	**USA**	Schulte Roth & Zabel LLP: Peter Jonathan Halasz & Richard A. Presutti	221

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This publication is intended to give an indication of legal issues upon which you may need advice. Full legal advice should be taken from a qualified professional when dealing with specific situations.

EDITORIAL

Welcome to the second edition of *The International Comparative Legal Guide to: Private Equity*.

This guide provides the international practitioner and in-house counsel with a comprehensive worldwide legal analysis of the laws and regulations of private equity.

It is divided into two main sections:

Four general chapters. These are designed to provide readers with a comprehensive overview of key private equity issues, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in private equity laws and regulations in 25 jurisdictions.

All chapters are written by leading private equity lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editors, Dr. Lutz Zimmer and Simon Rootsey of Skadden, Arps, Slate, Meagher & Flom LLP, for their invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at www.iclg.co.uk.

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1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions? Have you seen any changes in the types of private equity transactions being implemented in the last two to three years?

2015 was a robust year for M&A, particularly for high-value private equity transactions. Total dollar-denominated deal volume in U.S. private equity M&A increased 50 per cent over the previous year to $319.8 billion, although private equity deals constituted just 14 per cent of M&A deals in the U.S. in 2015. At its peak in 2007, private equity deals constituted 33 per cent of U.S. M&A activity. Particularly during early 2015, financing was readily available for many transactions, although sustained levels of M&A activity are dependent upon an environment of continued credit availability.

The most robust sectors by deal value in 2015 were information technology, healthcare and financial services. Activity in the energy market declined against 2014.

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

The largest contributing factors to private equity deal activity in the United States include, for buyers, the availability of debt financing at attractive interest rates, and for sellers, the fact that the cash many potential strategic buyers conserved during the economic downturn is now being deployed. The private equity deal market in the United States has also been supported by a global perception of economic stability. As long as the United States continues to enjoy "safe-haven" status, near-term deal activity is likely to remain robust.

2 Structuring Matters

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

Private equity buyers typically acquire private companies through a stock/LLC purchase, asset purchase, or reverse triangular merger structure, while public company targets are typically purchased through either a merger or tender offer. In a reverse triangular merger, the private equity buyer forms a "Newco" group, which includes a holding company – into which the buyer transfers the deal consideration – and a merger subsidiary, which merges with and into the target, with the target surviving such merger.

2.2 What are the main drivers for these acquisition structures?

Asset purchase structures are often chosen for tax reasons. Buyers often receive more favourable tax treatment in asset purchase structures, due to a stepped-up basis in the assets. Subject to certain exceptions, the structure also allows a buyer to avoid certain liabilities. However, this structure requires obtaining consents to assignment of contracts. Stock purchase structures only require consents for contractual change of control provisions and, in certain instances, an election can be made to treat stock purchases as asset purchases for tax purposes. In any event, every deal's unique characteristics must be considered when determining a tax efficient structure and split of liabilities between buyer and seller.

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

Equity-based compensation is customary in connection with any portfolio company investment and may take the form of stock options, restricted stock, restricted stock units, profits interests and phantom partnership interests.

In addition, private equity investors often permit or require management to re-invest a portion of the proceeds received in connection with an acquisition. Depending on the structure of the transaction, management's reinvestment or "roll over" of existing equity in a portfolio company may be accomplished without the members of management recognising taxable income.

2.4 What are the main drivers for these equity structures?

While certain private equity investors have a preferred form of equity awards, classification will depend on various factors, including:

- whether the portfolio company is organised as a corporation or limited liability company ("LLC");
- negotiation leverage by management;
- the form of equity awards held by management in the portfolio company prior to its acquisition;
- the expected exit strategy of the investor; and
- the size of the management team receiving equity awards.

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2.5 In relation to management equity, what are the typical vesting and compulsory acquisition provisions?

In general, management will become vested in their equity awards based on continued employment ("Time-Based Awards"), performance ("Performance-Based Awards") or a combination of both.

Time-Based Awards typically become vested over a period of continuous employment of at least three to four years.

Performance-Based Awards also become vested over a period of continuous employment, but are subject to the attainment of specified performance goals. In each year or other performance period, a portion of the award will vest based on the achievement of annual financial goals. Such performance goals may relate to the achievement of financial goals of the portfolio company, such as EBITDA, or based on the attainment of specified financial returns earned by the private equity investor (*e.g.*, IRR, multiple of capital/money or both). Goals based on the performance of the portfolio may be prescribed at the time of the award grant, or may be based on annual goals set by the portfolio company's board each year. Goals based on the specified financial returns earned by the private equity investor are ordinarily prescribed at the time of the award grant. In connection with the private equity investor's sale of the portfolio company (*e.g.*, a "change in control" or "liquidity event"), management employees generally will become vested immediately (*i.e.*, vesting is accelerated) in their Time-Based Awards; however, Performance-Based Awards might provide for accelerated vesting only if the applicable performance goals have been achieved prior to, or in connection with, the sale transaction (particularly where the goals are based on the attainment of specified financial returns earned by the private equity investor).

A portfolio company will typically retain a right to repurchase a management employee's equity, even if vested, in the event of employment termination. The price generally depends on the reason for the employee's termination. If the termination is on account of death, disability, the employee's involuntary termination without "cause" or voluntary termination for "good reason", the purchase price typically will be the fair market value of the equity. If the termination is for "cause" or the employee voluntarily terminated employment without "good reason", the employee's equity may be forfeited, without consideration, or repurchased at the lesser of the price, if any, paid by the employee or the current fair market value.

The requirements of Section 409A of the U.S. Internal Revenue Code of 1986, as amended, should be considered in connection with the grant of any form of management equity award. For example, Section 409A requires that stock options have an exercise price (or "strike price") equal to the "fair market value" of the underlying stock on the date of grant and have certain particular terms. Equity awards in the form of "restricted stock units" or "phantom units" may also be subject to the requirements of Section 409A, including strictly limiting payment or settlement of the award to pre-set triggers – death, disability, separation from service, change in control or a specified date.

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

Minority investors will seek to protect their economic interests, based on the size of their stake and their bargaining position relative to other investors. Typical structuring considerations likely include a combination of: pre-emptive, tag-along, and drag-along rights; restrictions or veto rights on amendments to the operating or shareholders agreement; the ability to appoint directors or observers to the board; and other negotiated veto rights (*see* question 3.2). Minority investors should seek the opinion of outside counsel to assess their exposure.

3 Governance Matters

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

Private equity investors typically own portfolio companies through an acquisition entity, most often an LLC, through which the private equity investor owns interests in, and controls governance of, the portfolio company. Governance structures vary widely, but most commonly the acquisition entity is controlled either by a managing member or a board of managers. Where several private equity investors own interests in the same portfolio company, the acquisition holding the company's operating agreement will also contain provisions governing the rights and obligations of each such investor with respect to the ownership and governance of the portfolio company, including certain economic rights (*e.g.*, rights to distributions, rights of first refusal, drag-along rights, pre-emptive rights, tag-along rights, etc.), and rights to appoint individuals to the board of managers. Sometimes, but not always, the portfolio company's chief executive officer (or other officer) may be appointed to the board of managers of the acquisition holding company. In general, governance arrangements must only be made publicly available if the portfolio company is a public reporting company.

Portfolio companies are often incorporated entities with their own boards of directors. Often, the senior officers of the portfolio company sit on the boards of portfolio companies, but because the sole shareholder of the portfolio company is usually the acquisition holding company, and because the acquisition holding company reserves the right to remove and replace the board and officers of the portfolio company, effective control over the portfolio company is vested at the acquisition holding company level. Nonetheless, day-to-day operational decisions are made by the officers of the portfolio company and its board of directors. Most often, portfolio company directors and officers are individuals with relevant industry and management experience, and do not include private equity investment professionals.

3.2 Do private equity investors and/or their director nominees typically enjoy significant veto rights over major corporate actions (such as acquisitions and disposals, litigation, indebtedness, changing the nature of the business, business plans and strategy, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Typical private equity governance structures are designed to ensure that the private equity owner has ultimate control over the portfolio company and any major decision with respect thereto. In structures in which multiple private equity funds control interests in the same portfolio company, it is typical that each private equity owner will negotiate for the right to exercise veto rights with respect to certain strategic decisions, such as the incurrence of indebtedness, sales of the company, significant asset sales, large capital expenditures and other key decisions, although the specific rights of any private equity investor vary widely based on deal-specific dynamics. Such veto rights are usually structured to fall away if the relevant private equity owner's interests are reduced below a given percentage.

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

Although the internal affairs doctrine holds that rights of shareholders and directors are governed by the laws of the state of the company's formation, in the context of veto rights for private equity owners (in the case of an acquisition holding structure with multiple shareholders) or any individual director, such veto rights are generally contractually granted, and any applicable limitations on their effectiveness are determined by the acquisition holding company's shareholder agreement (in the case of a corporation) or operating agreement (in the case of an LLC). While corporate director fiduciary duties (subject to certain limits) must remain unfettered, these concerns do not arise in the case of LLCs.

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

In the typical private equity acquisition holding company structure discussed above, the LLC operating agreement often includes an express waiver of the fiduciary duty of care owed by the majority owner to members holding minority interests, but one cannot waive the duty of loyalty. In the absence of a provision, there are no default fiduciary duties for LLCs in the Delaware statute, and the Delaware Court of Chancery will not read in fiduciary duties.

Although one can waive the duty of care owed by LLC majority owners, the duties of care and loyalty cannot be waived for directors of a corporation. In the case of a corporation with multiple private equity investors, there is typically a shareholder agreement containing an express acknowledgment that private equity firms engage in the business of investing, and therefore consider other opportunities and have access to proprietary information, and that such private equity investors have no obligation to the corporation or the other shareholders with respect to such opportunities or information. Duties of private equity investors to other minority shareholders, such as management with incentive equity interests, are typically waived in connection with the granting of such interests.

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

Generally, shareholder agreements must not contravene the certificate of incorporation and bylaws of the corporation, and any restrictions on shareholder agreements lie in the jurisdiction of incorporation. Pursuant to the internal affairs doctrine, corporate governance and internal documents must be governed by the laws of the state of incorporation, but jurisdiction can lie outside of such state. Fiduciary duties cannot be carved out.

LLCs have greater flexibility than corporations, as the members of LLCs govern their affairs through an operating agreement, which is a contract negotiated and agreed by the members. In the case of most states, state law is drafted to assure a significant amount of flexibility for LLC members to negotiate the terms of their agreement.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies under corporate law and also more generally under other applicable laws (see section 10 below)?

Generally, there are no special requirements for an investor nominating directors. Corporate directors owe the fiduciary duties of care and loyalty to all shareholders (including management that holds equity) of the portfolio company. Since private equity director nominees are usually members, managers or employees associated with the private equity owner, these directors also owe duties to the limited partner investors in the private equity fund. Conflicts of interests may arise in the context of transactions between the portfolio company and the fund. These considerations are why LLCs are typically used *in lieu* of corporations.

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

Pursuant to the fiduciary duty of loyalty referenced in question 3.6, directors must disclose conflicts of interest and must not usurp for themselves corporate opportunities that would benefit the corporation without disclosure to the board. LLC operating agreements can carve out the fiduciary duty of loyalty to avoid these conflicts.

4 Transaction Terms: General

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

Subject to certain exceptions and exemptions, transactions in the United States involving more than $78.2 million in transaction consideration are subject to filing and review by the Federal Trade Commission ("FTC") and the Department of Justice ("DOJ") under the Hart-Scott-Rodino Act ("HSR"). The standard waiting period for filing parties is 30 days, but parties can request early termination of the waiting period (usually 14–21 days). If a transaction raises anticompetitive concerns, it could receive a "second request" for more filing information and extended review time.

In addition to HSR, transactions in certain sectors may be subject to other regulatory approvals before a transaction can be consummated. For example, the Committee on Foreign Investment in the United States ("CFIUS") may review transactions in which foreign buyers are to purchase U.S. companies and which may affect national security, and if a transaction has been consummated prior to CFIUS approval, and if CFIUS then undertakes an investigation, divestment of the acquisition may be ordered. In practice, such divestiture orders are very rare.

In addition to regulatory matters, purchase agreements sometimes contain contractually imposed conditionality to the parties' obligations to consummate a transaction, such as the obtainment of

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key consents, novations of key contracts, or, in some instances, the availability of debt or equity financing.

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

As deal value has increased, financing contingencies have become more rare in private equity deals. This has in part led to reverse break fees (that is, a payment to the target company if a buyer backs out of a deal) becoming increasingly common since the 2008 financial crisis, particularly in deals in which the buyer is a private equity fund. In such deals, the reverse break fee is usually the sole remedy if debt financing is not available, and in the vast majority of deals, the target has a limited specific performance right to force the buyer to close only if the debt financing is available.

While "go-shop" provisions (which allow a target company to seek better offers for a prescribed period after it has entered an agreement to sell itself) are not standard, they continue to be widely used, although more target companies are engaging in pre-signing market checks instead of relying on such "go-shop" provisions.

5 Transaction Terms: Public Acquisitions

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

In addition to the ordinary disclosure requirements under the United States securities laws that are applicable to public merger and acquisition transactions, some going-private transactions – engaged in by the target or the target's "affiliate" and resulting in either (i) delisting from an exchange, or (ii) a class of the company's equity securities being held by fewer than 300 persons – are subject to Rule 13e-3 under the U.S. Securities Exchange Act of 1934. Rule 13e-3 requires more disclosure than is usually required by the federal proxy rules or tender offer rules. Among other requirements, the participating parties and the target must attest to the fairness of the transaction and disclose information about the private equity sponsors and funding of the transaction. Transactions, including those subject to Rule 13e-3 that involve a tender offer, are governed by specific tender offer rules. Transactions that involve shareholder votes are governed by proxy rules. Finally, transactions that involve issuance of securities are governed by the registration and prospectus requirements.

Disclosure requirements and various other requirements affect the timing of the transaction, including the target board's evaluation of the transaction, bank syndication and the sale of debt securities, antitrust and other regulatory review, solicitation of proxies or tenders, as well as the creation of special purpose vehicles. Hiring a competent team of professionals, including lawyers, accountants, proxy solicitors, PR professionals and others is essential to navigating these processes.

5.2 Are break-up fees available in your jurisdiction in relation to public acquisitions? If not, what other arrangements are available, e.g. to cover aborted deal costs? If so, are such arrangements frequently agreed and what is the general range of such break-up fees?

In acquisitions of public company targets, break fees are available to compensate the buyer when the target terminates to accept another deal. Additionally, if the target board decides not to recommend the deal to its shareholders, the buyer can usually immediately terminate and collect a break fee. Over the past few years, the mean break fees for large market and middle market deals each hover around 2.5 to 3.5 per cent of the equity value. A majority of "go-shop" provisions provide for a smaller break fee than would apply during the "no-shop" period. For a specified period of time, a break fee can also be triggered during a "fee tail" that applies if shareholders vote down the original merger agreement due to the likelihood that a better deal will arise and then, defining a period after termination, the target does actually sign or close another deal. Alternatives to break fees – though not mutually exclusive – include specific performance provisions and money damages.

Buyers reduce the risk of a competing offer arising by including in the transaction agreement a '"no-shop" provision to restrict the target company from taking actions that increase the likelihood that another bidder will make a competing offer to acquire the target. Because a public company board of directors has a fiduciary duty to get the highest price for the shares of the company, "no-shops" include a "fiduciary out" escape valve that allows the board to terminate an acquisition agreement to accept an unsolicited superior offer. In this case, the original buyer would receive the break fee.

6 Transaction Terms: Private Acquisitions

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

Consideration structures in private equity transactions vary broadly, and will always depend on deal dynamics and the investor profile of the private equity investor(s) involved in a transaction. In a leveraged buyout scenario, the private equity buyer negotiates for, and arranges, a buyer-side credit facility, and in these transactions, the target company is typically acquired on a cash-free and debt-free basis. In some instances, however, the target company's existing credit facility is considered a valuable asset, and the parties may negotiate to keep it in place after closing (although this often requires the consent of the lender).

Private equity buyers often negotiate for a target working capital mechanic, where the consideration to be paid by the buyer at closing is adjusted up or down depending on the variance between working capital at closing and a pre-negotiated target working capital amount. In addition to working capital adjustments, private equity transactions can include cash covenants, earnouts, contingent value rights and other creative consideration structures.

Private equity sellers desire to promptly distribute funds following a sale, and in order to facilitate this, will often negotiate for representation and warranty insurance to be the principal source of recovery for breaches of the seller's representations and warranties. Buyers, in contrast, seek to ensure adequate resources to protect them against certain risks.

6.2 What is the typical package of warranties/indemnities offered by a private equity seller and its management team to a buyer?

Post-closing indemnification provisions are often the most heavily negotiated deal terms in private equity acquisitions. In the typical arrangement, management is not personally liable for indemnities. When a public company is being acquired, there typically is no post-closing indemnification because all material information about

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the target company has been disclosed to the buyer in the target company's filings with the Securities and Exchange Commission ("SEC"), and because seeking recovery against a broadly held shareholder base is impractical.

Special indemnities are used to protect the buyer from matters that arise in its due diligence review. Special indemnities can also be used to protect the buyer from shareholders of the target exercising appraisal rights. In many deals, the seller agrees to indemnify the buyer for pre-closing taxes that are owed by the target. This ensures that the sellers, who received the benefit of past earnings, pay the taxes associated with those past earnings. It also allows the purchase price to be calculated without having to diligence and estimate potential tax liabilities. Special indemnities may also cover deal expenses or the cost of obtaining any third-party consents under change-in-control provisions.

To provide comfort as to payment of indemnity, in private target deals, part of the deal consideration is often placed in an escrow account. Such escrow arrangements are used in roughly 90 per cent of private deals. The escrow period is typically one to two years and tends to track the survival of the reps and warranties. Escrow size ranges from 5 per cent to 15 per cent of deal value. In most private deals, the size of the escrow is equal to the indemnity cap for breaches of basic representations and warranties, which usually limits recovery for such breaches to approximately 10 per cent to 20 per cent of deal value in the aggregate. In about a third of private equity deals, the escrow holdback is the exclusive source of recovery for target company reps.

As further discussed below, private equity sellers will generally negotiate several limitations on their obligations to pay indemnities. These limitations include: time limitations; *de minimis* exclusions; deductibles or baskets; caps; and categorical exclusions. There can also be carve-outs from these limitations.

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

In addition to the indemnities discussed above, the buyer and seller will negotiate to include covenants restricting the sellers' actions after closing, including their ability to enter into business in competition with the target or to solicit the target's employees and customers.

Generally, the seller's management does not personally make representations, covenants, or other undertakings, but often enters into non-competition and non-solicit covenants as part of the negotiations in connection with the transaction.

6.4 Is warranty and indemnity insurance used to "bridge the gap" where only limited warranties are given by the private equity seller and is it common for this to be offered by private equity sellers as part of the sales process? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such warranty and indemnity insurance policies?

Policies are often used strategically in the United States. Private equity buyers occasionally use insurance as an alternative where the seller provides little or no indemnification. Sellers use insurance as an alternative to tying up money in escrow for a long period of time or giving a funding guarantee. While a "public style" deal with no seller indemnity and insurance as the sole recourse is possible, the most common structure features a limited seller indemnity (approximately one per cent of enterprise value) with a representations and warranty insurance policy for 10 per cent or more of enterprise value (as a source of secondary recovery behind the seller indemnity). Buyers have historically used this structure to gain an advantage in a competitive auction, but more and more frequently, sellers are proactively pitching this structure to the field of potential bidders as the required indemnity structure in order to achieve a cleaner exit and distribute funds to investors without significant holdbacks and escrows in respect of the seller indemnity. Insurance policy limits, survival periods and deductibles vary dependent on the premium the parties are willing to pay; however, coverage can approximate what a buyer would receive in a traditional indemnity structure. Insurers universally demand anti-sandbagging provisions as a condition to coverage, and often exclude from coverage breaches occurring between signing and closing. Other carve-outs may apply in particular industries, but are generally deal-specific.

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

Generally, indemnification obligations of target company stockholders for reps and warranties extend for one to two years post-closing. However, reps and warranties concerning tax, employee benefits and environmental matters usually last until expiration of the underlying statute of limitations.

Most agreements include caps on losses arising from breaches of reps and warranties. Caps for reps relating to the target company's condition range from 10 per cent to 20 per cent or less of the purchase price. Fundamental matters are generally capped at the purchase price. Losses from breaches of covenants are usually not capped.

In addition to caps, transaction agreements typically require losses to exceed a "basket" amount before the company must pay the indemnification. The amount is usually 0.5 per cent to 1 per cent of the purchase price. Some agreements include tipping baskets, in which the amount owed in indemnity includes not only the amount over the basket, but also the total amount from the first dollar before the basket level was reached. In stock purchase and merger transactions, seller stockholders (which include, in private equity transactions, the one or more private equity sellers party to the transaction) are usually responsible *pro rata* for providing indemnification to the buyer.

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

The level of security a seller provides in a transaction is dependent on the negotiating dynamic between the parties. It is not uncommon for sellers to agree to an escrow to backstop representations and warranties and to protect against known risks.

Recently, however, bidding strategies used by buyers have included foregoing certain contractual protections in favour of insurance for such risks.

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6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain if commitments to, or obtained by, an SPV are not complied with (e.g. equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

Private equity deals usually require at least two sources of financing: equity financing from the private equity fund; and debt financing from third-party lenders. Each source of financing is usually supported by a commitment letter that is signed at the same time the acquisition agreement is entered into. The target, though not a party to the equity commitment letter, usually receives enforcement rights under the equity commitment letter that come in either of two forms. In some deals, the target is named as an express third-party beneficiary under the equity commitment letter. In other deals, the target can use its specific enforcement right in the merger agreement against the parent of the SPV, making the parent of the SPV pursue its remedies against the private equity fund that provided the equity commitment. The target often has a similar specific enforcement right against the committed lender for the debt financing. Any condition in the third-party lender's commitment letter should conform to the equivalent condition in the buyer's acquisition agreement.

Participants in private equity transactions commonly negotiate guarantees from the private equity fund in circumstances where a parent SPV has agreed to pay a reverse break fee. The fund may also guarantee to pay damages capped at the same amount as the reverse break fee.

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

Though sometimes used in tender offers, financing conditions are increasingly rare in private equity deals. A reverse break fee is the most common alternative. Historically, as many as 90 per cent of private equity deals use a financing failure reverse break fee structure. Under a reverse break fee, the buyer is permitted to terminate the transaction upon payment of a negotiated fee if it is unable to obtain its debt financing despite having used sufficient efforts to do so.

If the reverse break fee is triggered, it is normally the sole and exclusive remedy. The target cannot sue for specific performance or waive the fee and sue for damages. Failed regulatory approvals can trigger a reverse break fee. Usually this reverse break fee is payable only if all the conditions to the buyer's obligations (other than regulatory approval) have been satisfied. In some deals, the reverse break fee is triggered by a material breach of a representation, warranty or agreement. Reverse break fees are used in both middle and large market deals with public targets, but are more common in large market deals. Over the past few years, the mean break fees of large market and middle market deals each hover between five and seven per cent of the equity value.

7 Transaction Terms: IPOs

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

IPOs are a popular exit strategy among private equity sellers. With the ideal market conditions, an investor can maximise its ROI through higher and predictable valuation, and the portfolio company would have greater access to capital than with other forms of exits. One disadvantage with an IPO is that it is not an actual exit; rather it is the first step, and the private equity seller only truly exits its investment when its shares are sold in the market. Consequently, private equity sellers may be exposed to market risks including fluctuations in the price of shares for a given period of time, during and after a lock-up period.

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

IPO underwriters typically require a lock-up agreement to prohibit a private equity seller from selling its shares in the portfolio company for up to 180 days following the IPO. While a 180-day lock-up is typical, underwriters have entered into lock-up waivers in connection with secondary offerings. In addition, since private equity sellers are insiders, they still may not be able to sell a large portion of their shares after the lock-up period expires.

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

Private equity buyers commonly engage in dual-track processes, and the commitment point varies dependent on other factors, including market window, credit availability and the availability of potential buyers. To facilitate an IPO or other public offering, private equity investors typically put in place registration rights that govern the rights of shareholders in the event of an IPO.

8 Financing

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

The most common sources of debt used to fund private equity transactions in the United States are generally classified by their tiers or layers, which may include senior secured debt, subordinated debt (either structurally or contractually) or mezzanine debt (which is typically subordinated and contains an equity component for the financing sources). Senior secured credit facilities typically include: working capital facilities (in the form of asset-based revolving credit facilities or cash flow revolving credit facilities) and term credit facilities in the form of term loan A debt (which typically include a higher percentage of amortisation payments with a smaller

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bullet payment at maturity); first lien debt or first-out debt (which is typically amortised evenly over several years and repaid in equal installments); term loan B debt (which is typically amortised at a rate equal to one per cent *per annum*); and junior lien debt or last-out debt (which is amortised nominally over several years with a large bullet payment at maturity). In addition to the secured credit facilities a portion of the debt financing may be in the form of bonds that are secured (which may be secured by certain assets on a first, junior or "crossing" liens basis), unsecured or subordinated. Private equity funds may look to the high yield debt market to provide long-term debt financing without the financial covenants and other restrictions which would normally be found in credit facilities.

It is worth noting that if there are financing sources providing commitments in connection with a proposed transaction, such financing sources may require the private equity fund to provide an equity contribution. The equity contribution would be used to partially fund the transaction.

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

Although the Dodd-Frank Act introduced a broad swath of new regulation for private equity funds, the landscape with respect to structuring private equity debt financing remains largely unregulated by these regulations. There have been recent developments in lending guidelines (such as Interagency Guidance on Leveraged Lending (the "Guidelines")) which may impact the ability to obtain financing from regulated banks and the overall covenant protections in the credit agreements. However, there has been an increase by "shadow" banks (and other lending institutions that are not subject to the Guidelines) providing the debt financing necessary to consummate a transaction. As of the date of this publication, it is unclear as to the impact the Guidelines may have on the cost of obtaining debt financing (*i.e.* commitment fees, interest rate, amortisation and/or original issue discount/upfront fees).

9 Tax Matters

9.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction?

Non-U.S. investors making private equity investments in the United States have to carefully analyse the nature of the type of investment assets they are investing in and the investment vehicles that they will be investing through. The U.S. tax system imposes a myriad of different taxes on different types of income and different types of taxpayers. Among these are net income taxes on U.S. income from trades or businesses that are effectively connected with the United States, gross withholding taxes on interest, dividends, royalties and other types of passive or periodic income, branch profits taxes earned by non-U.S. corporations and capital gains taxes imposed on investments in U.S. real property, either directly or through U.S. property holding corporations. There are numerous exceptions from tax that are available to mitigate the impact of these taxes, either under domestic U.S. legislation or pursuant to the tax treaties in force with the United States. Matching the types of income expected to be earned with an investment structure that takes advantage of available exceptions is critical to successful private equity investing in the United States. In addition, many non-U.S. taxpayers should be particularly attuned to structuring their investment in U.S. private equity funds to minimise the need to file tax returns in the United States. Other non-U.S. taxpayers may want to maintain confidentiality of their identities through the use of appropriate investment structures in order to ensure that the U.S. tax system does not establish direct jurisdiction over the investors or enable the United States to exchange information with the investors' home governments where such entanglement in the U.S. tax system could be problematic.

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

The structure of a transaction generally is determinative of whether a management team member will be required under U.S. tax law to recognise any taxable income with respect to the equity (vested equity) of the portfolio company that the management team member holds. In general, any such gain will be taxable as short-term or long-term capital gain depending on how long the management team member held such equity. However, whether the management team can roll over their equity on a "tax-free" basis typically is not a driving consideration in designing the structure of a transaction.

In addition, depending on the structure of the transaction (*e.g.*, a tax-free reorganisation), certain equity-based compensation awards, such as stock options, held by management could be assumed or "rolled over" into the new acquisition structure without causing management to recognise taxable income. However, where the equity-based compensation is being paid or settled in connection with the transaction, the management team members generally will not be able to avoid recognising taxable income. Importantly, the requirements of Section 409A of the U.S. Internal Revenue Code must be considered in connection with the rollover of any equity awards that were designed to be paid or settled upon a sale of the portfolio company (or similar transaction). The rollover of certain equity awards, such as "restricted stock units" or "phantom units", could constitute an impermissible deferral of compensation that triggers penalty taxes under Section 409A.

9.3 What are the key tax-efficient arrangements that are typically considered by management teams in private equity portfolio companies (such as growth shares, deferred / vesting arrangements, "entrepreneurs' relief" or "employee shareholder status" in the UK)?

Where a portfolio company (or other entity holding equity of the portfolio company) is formed as a partnership, "profits interests" are generally viewed as the most management-friendly form of equity-based compensation. In general, a "profits interest" is an interest in a partnership or limited liability company other than a "capital interest" – an interest that provides the holder with a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in complete liquidation of the partnership. While a profits interest is economically similar to a stock option by providing the holder with a share of the entity's future appreciation, it can be treated as a transfer of property under U.S. tax law, even if subject to future vesting (typically, holders of profits interests file elections, called "83(b) elections", help ensure such treatment). Under U.S. tax law, a profits interest should have zero value upon grant, and therefore, a recipient of a profits interest should not recognise any taxable income upon its receipt. Depending on how long a management team member holds a profits interest before a subsequent sale of the portfolio company (or the profits interest), the full value of the proceeds received by the profits interest holder could be treated as capital gain or loss by the holder. One perceived drawback of profits interests is that the recipient

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must be treated as a partner of the entity in which the profits interest was granted, and therefore, must receive a Schedule K-1 from the partnership.

In general, other equity-based compensation awards, such as stock options, restricted stock units or "phantom" equity, generally cause a management team member to recognise ordinary income upon payment or settlement. Accordingly, those equity awards generally are not perceived as being as tax-efficient as profits interests.

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

Notably, legislation has been proposed on numerous occasions over the past six years to eliminate the tax-favourable treatment of carried interests earned by sponsors of private equity funds. This legislation has still not come to a vote. However, other notable tax legislation has affected U.S. private equity investment. In 2010, for example, the United States enacted the Foreign Account Tax Compliance Act and since then the U.S. Treasury Department has promulgated extensive regulations enabling the FATCA regime. FATCA imposes substantial withholding taxes on, among other things, foreign financial institutions and other foreign enterprises receiving payments from U.S. sources unless such organisations comply with extensive rules to ensure that foreign financial assets of U.S. taxpayers have been appropriately disclosed. As the U.S. implemented the FATCA regime, many other governments around the world (and the OECD) determined that they should be entitled to determine who is behind financial accounts where the beneficial ownership is not immediately apparent. Accordingly, account holder identification and certification requirements have been increasing for private equity investors both within and outside of the U.S.

At the end of 2015, legislation was enacted which overhauled the income tax audit procedures for U.S. partnerships (including LLCs and other entities that are treated as partnerships for U.S. tax purposes). Under prior rules, known as the TEFRA audit procedures which dated from 1982, audits of partnerships were undertaken at the partnership level but the collection of any tax liability arising from such audits was done at the level of the partners in the partnership. In private equity partnerships where an income producing partnership may be owned through tiers of intervening partnerships, the IRS was often unable to collect the taxes due without significant additional effort to move up the tiers until they reached the ultimate taxpayer. Under the new legislation, audits will still be conducted at the partnership level but any tax liability arising out of such audit will, in the first instance, be required to be paid by that partnership. While certain exemptions exist that may permit the tax to be paid by the partners (or by their partners) such exemptions carry with them obligations that the partners actually pay the tax and certain increases in the computation of the amounts due. For private equity partnerships, these rules will require some realignment of the interests of the parties. Tax exempt investors, for example, will have little interest seeing a partnership tax liability arise from a partnership they are invested in and will insist that any such taxes that are paid at the partnership level be allocated to or indemnified by the taxable investors in the partnership. In cases where the ownership of the partnership has changed between the year under audit examination and the year the tax payment is due, parties will have to be careful to ensure that the right party ultimately bears the economic cost of the additional taxes due.

10 Legal and Regulatory Matters

10.1 What are the key laws and regulations affecting private equity investors and transactions in your jurisdiction, including those that impact private equity transactions differently to other types of transaction?

The principal sources of law affecting private equity investors and transactions in the United States are as follows:

1. *State law of a company's state of incorporation.* U.S. corporations are incorporated under the laws of the individual states, and accordingly, every U.S. corporation is governed in the first instance by the laws of its state of incorporation and corresponding cases interpreting these laws.
2. *Federal statutes and the rules and regulations adopted pursuant to these statutes by the "SEC".* All public companies are subject to regulation by the SEC pursuant to at least two principal statutes: (i) the Securities and Exchange Act of 1934 (the "Exchange Act"); and (ii) the Securities Act of 1933 (the "Securities Act"). The Exchange Act requires annual, quarterly and periodic reporting by public companies, requires stockholders of such companies to file reports upon crossing certain ownership thresholds, and regulates, in part, the process by which stockholder votes are solicited. The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), which imposed additional corporate governance-related requirements on public companies, is part of the Exchange Act. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") added provisions to the Exchange Act granting regulators broader discretion to regulate corporate governance matters, including executive compensation and proxy access. Dodd-Frank required certain private equity funds to register under the Investment Advisers Act of 1940 (the "Advisers Act"), discussed more in 10.2.
3. *A corporation's organisational documents.* An additional important source of requirements is the organisational documents of the corporation. Each corporation will be governed by a minimum of two documents: the certificate of incorporation, or "charter", and the bylaws. Either or both of these documents will contain important provisions regarding board composition, annual meetings, stockholder rights, and other aspects of the entity's corporate governance. In addition, reporting companies with listed securities are required to have written charters for various committees of the board of directors, and in some cases, companies may have additional documents setting out additional rights for various classes of shares or convertible securities.
4. *Other sources*. The New York Stock Exchange ("NYSE") and other exchanges require listed companies to abide by certain corporate governance standards and regulations. Additionally, industry groups, stockholder advisory services, and in some cases, institutional investors may also publish non-binding corporate governance guidelines and recommendations.

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

As of August 2013, the new Section 251(h) of the DGCL provides for parties to enter merger agreements that can "opt in" to the statute to eliminate the shareholder vote on the back-end merger following a tender offer. The acquirer must obtain a sufficient amount of votes (usually more than 50 per cent) such that its vote alone would be sufficient to approve the merger. Before the change, acquirers

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faced two options: a higher hurdle of obtaining 90 per cent (or if not, complete a back-end merger) of the vote; or a more expensive, time-consuming "top up" option in which the target issued more shares for the acquirer to reach 90 per cent. Tender offers may become more popular as a result of the new Section 251(h). The new Section 251(h) facilitates financing of a tender offer because the lender no longer has to wait for a back-end merger.

10.3 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g. typical timeframes, materiality, scope etc.)? Do private equity investors engage outside counsel / professionals to conduct all legal / compliance due diligence or is any conducted in-house?

Dependent on factors such as deal size, complexity, and the adequacy of corporate controls, a private equity investor may engage in very in-depth diligence through outside counsel. Legal due diligence is conducted with regard to corporate governance and standing, environmental issues, regulatory considerations, pending or potential litigation, real property and asset holdings, employment policies and procedures, customer-and-supplier contracts, debt arrangements, intellectual property, and other legal obligations. Diligence may, depending on the transaction, range anywhere from several days to several months. Scope and materiality may vary based upon those same parameters.

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

The U.S. Foreign Corrupt Practices Act of 1977 ("FCPA") merits consideration by private equity investors whenever the target has foreign government customers or conducts operations overseas. It is customary for the acquirer to obtain appropriate contractual representations warranting the target's compliance with the FCPA and other applicable anti-bribery and anti-corruption laws. It also is customary for the acquirer to conduct FCPA due diligence on the target's anti-bribery compliance procedures and controls, the target's agents and other third-party intermediaries who interact with foreign officials on its behalf, and the existence of any current or prior bribery-related allegations or investigations. Not infrequently, the acquirer's FCPA due diligence will uncover issues that may warrant further investigation, remedial action by the target, disclosure of apparent violations to government authorities in the United States and other jurisdictions, and/or delays in, or even termination of, the contemplated transaction. The U.S. DOJ and SEC have made clear that they expect prospective acquirers to conduct pre-acquisition due diligence and will assess the quality of the acquirer's due diligence in determining whether to impose successor liability for pre-acquisition violations and the magnitude of any sanctions that are imposed.

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

Under the U.S. Employee Retirement Income Security Act of 1974, as amended ("ERISA"), all members of a "controlled group" have joint and several liability for underfunded defined benefit pension plans sponsored by any member of the group (including any "withdrawal liability" from a union multiemployer pension plan). In general, a "controlled group" will consist of a corporation or other "trade or business" and any entity in which it (directly or indirectly) holds at least an 80 per cent interest, including parent-subsidiaries and brother-sister entities. In general, control of a corporation is based on stock ownership (both in terms of its voting power or economics), while control of a partnership (and any entity taxed as a partnership) is based on ownership of profits interests or capital interests. In the private equity context, it has long been argued that a private equity investor, typically organised as a limited partnership, is not a "trade or business" for this purpose, and therefore, not part of a portfolio company's controlled group – even if the investor owns an 80 per cent or more interest in the portfolio company. In recent years, however, both the Appeals Board of the PBGC and U.S. courts have ruled that particular private equity investors had indeed engaged in sufficient activities with respect to their respective portfolio companies to constitute a trade or business. Such decisions have heightened the concern that a private equity investor could be liable for the pension liability of its portfolio company.

11 Other Useful Facts

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

The purchase of a unionised employer raises collective bargaining and workplace flexibility issues. Private equity buyers seeking to acquire a business having a single employer defined benefit plan, or contributing to a multiemployer defined benefit plan, must consider potential liabilities arising from the plans. Experienced employment and employee benefits counsel is vital in navigating this area.

The United States has an extremely well-developed, sophisticated and highly efficient environment for private equity deal-making. As a result, investors seeking to participate in the opportunities provided by the large U.S. private equity market can and should take advantage of the professionals experienced in this market and the regulatory framework that surrounds it, including private equity lawyers and others.

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