



# ICLG

The International Comparative Legal Guide to:

## Private Equity 2015

**1st Edition**

A practical cross-border insight into private equity

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Aabø-Evensen & Co

Ali Budiardjo, Nugroho, Reksodiputro

Angola Capital Partners

Anjarwalla & Khanna

Ashurst LLP

Bär & Karrer AG

Bentsi-Enchill, Letsa & Ankomah

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Houthoff Buruma

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Simont Braun

Skadden, Arps, Slate, Meagher & Flom (UK) LLP

Țuca Zbârcea & Asociații

Veirano Advogados

Vieira de Almeida & Associados,

Sociedade de Advogados, RL

Zhong Lun Law Firm

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**Contributing Editor**

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Meagher & Flom (UK) LLP

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**Group Consulting Editor**

Alan Falach

**Group Publisher**

Richard Firth

**Published by**

Global Legal Group Ltd.  
59 Tanner Street  
London SE1 3PL, UK  
Tel: +44 20 7367 0720  
Fax: +44 20 7407 5255  
Email: info@glgroup.co.uk  
URL: www.glgroup.co.uk

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## EDITORIAL

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Welcome to the first 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 22 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 editor, Shaun Lascelles of Skadden, Arps, Slate, Meagher & Flom (UK) LLP, for his 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](http://www.iclg.co.uk).

Alan Falach LL.M.  
Group Consulting Editor  
Global Legal Group  
[Alan.Falach@glgroup.co.uk](mailto:Alan.Falach@glgroup.co.uk)

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# USA

Peter Jonathan Halasz



Richard A. Presutti



## Schulte Roth & Zabel LLP

### 1 Overview

#### 1.1 What are the most common types of private equity transactions in the United States and what is the current state of the market for these transactions?

2014 was a very active year for mergers and acquisitions generally, and private equity transactions were no exception. Enticed by attractive valuations (2014 deal valuations in the overall U.S. mergers and acquisitions market exceeded ten times EBITDA), many private equity firms have taken advantage of opportunities to sell portfolio companies. Access to financing has led to a shift in focus on the buy-side to larger transactions with a longer investment horizon. In terms of number of transactions, the middle market of private equity mergers and acquisitions (between \$250 million and \$750 million deal value) was flat in 2014, although there were significantly more private equity transactions valued in excess of \$750 million.

Private equity deal activity in the United States has been robust across sectors, but the largest sectors by deal value in 2014 were retail, computer and electronics, health care and oil and gas, although volatility in oil and gas prices is likely to affect deals in this segment in 2015. Private equity investment in distressed deals has decreased broadly, with fewer distressed opportunities in the current economic climate.

#### 1.2 What are the most significant factors or developments encouraging or inhibiting private equity transactions in the United States?

The largest contributing factors to private equity deal activity in the United States include, for private equity buyers, the availability of debt financing at attractive interest rates, and for private equity sellers, the fact that many potential strategic buyers conserved cash over the course of the economic downturn and are now displaying confidence to deploy resources to make acquisitions. 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, deal activity within the United States is likely to remain robust in the near term.

### 2 Structuring Matters

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

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 of this holding company, 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, because the buyer gets a stepped-up basis in the assets. Subject to certain exceptions, the structure also allows a buyer to leave certain liabilities with the seller. The downside is that the 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, although this can create an adverse tax consequence for the seller. 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, but the relative bargaining power of the parties is likely to determine which receives various structure benefits.

#### 2.3 How is the equity commonly structured in private equity transactions in the United States (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 (such as the sale of any previously held equity) received in connection with the acquisition of their company in the portfolio company. 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 at such time.

#### 2.4 What are the main drivers for these equity structures?

While certain private equity investors have a preferred form of equity awards, the type of private equity awards will depend on a number of factors, including:

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

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

In general, equity awards are divided into two tranches – one tranche becoming vested based on continued employment ("Time-Based Awards") and one tranche becoming vested based on performance ("Performance-Based Awards").

Time-Based Awards typically become vested over a period of at least three to four years. One type of Performance-Based Award becomes vested over a period of several years. In each year, a portion of the Award will vest based on the achievement of annual financial goals, such as EBITDA or a similar type of annual performance measure. A second type of Performance-Based Awards becomes vested based on the achievement of certain financial returns earned by the sponsor (e.g., IRR, multiple of capital/money or both). In connection with the private equity investor's sale of the portfolio company, all or a portion of the Time-Based Awards and Performance-Based Awards typically become fully vested.

A portfolio company typically will hold a right to repurchase the employee equity in the event of employment termination. The price generally depends on the reason for the employee's termination. If the termination was 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 was 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.

### 3 Governance Matters

#### 3.1 What are the typical governance arrangements for private equity portfolio companies?

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 (often the private equity fund or a principal thereof) which has the sole authority to direct the management of the portfolio company, or by a board of managers (often private equity investment professionals who were involved in the relevant acquisition, or other principals of the private equity fund). 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, preemptive 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.

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.)?

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.

#### 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 governing law and jurisdiction)?**

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?**

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 the United States, 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 \$76.3 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 obtaining of 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 breakup 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 of 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 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 fees available in the United States in relation to public acquisitions? If not, what other arrangements are available, e.g. to cover aborted deal costs?

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 3 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 in the United States?

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.

### 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 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 1 to 2 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 discussed more 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?

Policies are often used strategically in the United States. Private equity buyers occasionally use insurance as an alternative where there is either no indemnification or very limited indemnification provided by a seller. Sellers use insurance as an alternative to tying up money in an 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 1 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.

### 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 How do private equity buyers typically provide comfort as to the availability of equity finance and what rights of enforcement do sellers typically obtain if commitments are provided by SPVs?

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.

### 6.7 Are reverse breakup 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 breakup fee is the most common alternative. Approximately 90 per cent of current 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 5 per cent to 7 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 To what extent can rights in pre-existing shareholders' agreements survive post-IPO?

Rights entitling certain shareholders to participate in future securities offerings and maintaining certain levels of ownership can survive post-IPO. Similarly, certain board rights, such as maintaining observer status on a board, can survive IPOs. Finally, equity incentive plans adopted prior to an IPO can be "grandfathered" in post-IPO.

## 8 Financing

### 8.1 Please outline the most common sources of debt finance used to fund private equity transactions in the United States and provide an overview of the current state of the finance market in the United States for such debt.

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 and subordinated or mezzanine debt. Senior secured debt typically includes working capital facilities (in the form of revolving credit facilities), term debt in the form of term loan A debt, first lien debt or first-out debt (which is typically amortized evenly over several years and repaid in equal installments), and term loan B debt, second lien debt or last-out debt (which is amortized nominally over several years with a large bullet payment at maturity). Subordinated or mezzanine debt typically is unsecured and carries a higher rate on interest than the senior secured debt. In some cases, mezzanine debt provides for all or a portion of the interest that accrues thereon to be paid-in-kind ("PIK").

After the market contractions resulting from the 2007-2009 financial crisis in the United States, the mezzanine fund market grew swiftly and continues to expand as a common source of private equity debt. Despite the market contractions, staple financing (or pre-arranged financing packages) are less common in the current market.

### 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

regulations for private equity funds, the landscape with respect to structuring private equity debt financing remains largely unregulated by the new rules. However, there have been recent developments in the application of fraudulent transfer laws to private equity-related transactions structured as leveraged buy-outs or dividend recapitalisations. Accordingly, the structure of debt financings in these contexts must take into account the legal restrictions surrounding fraudulent conveyance law to mitigate the risk of running afoul of federal and state fraudulent conveyance statutes.

## 9 Tax Matters

### 9.1 What are the key tax considerations for private equity investors and transactions in the United States?

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 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 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 or 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.

## 10 Legal and Regulatory Matters

### 10.1 What are the key laws and regulations affecting private equity investors and transactions in the United States, 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 question 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 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 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.

### 10.4 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies; and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

Generally, investors of a portfolio company are not subject to liability for the portfolio company's actions or omissions except in limited circumstances, such as in cases asserting alter ego or similar claims seeking to pierce the corporate veil and disregard the protections of limited liability. Although the laws of each jurisdiction vary, veil-piercing claims typically require a showing that: (i) the investor exercised an excessive amount of control over the portfolio company; (ii) the investor abused that control through some wrongdoing; and (iii) such abuse of control caused harm. Courts consider a number of factors to determine whether there has been excessive control or abuse of control, including the size of the investor's interest in the portfolio company, the scope of the investor's involvement in the portfolio company's management, and whether appropriate corporate formalities have been observed.

## 11 Other Useful Facts

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

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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### Peter Jonathan Halasz

Schulte Roth & Zabel LLP  
919 Third Avenue  
New York, NY 10022  
USA

Tel: +1 212 756 2238  
Fax: +1 212 593 5955  
Email: [peter.halasz@srz.com](mailto:peter.halasz@srz.com)  
URL: [www.srz.com](http://www.srz.com)

**Peter Jonathan Halasz** is a partner in the Investment Management and Business Transactions Groups at Schulte Roth & Zabel LLP. Educated in both law and business, his practice includes mergers and acquisitions, securities, private equity, international business and investment funds. In the area of private equity M&A, he has represented clients in auctions and sales, restructurings and leveraged capitalisations, mergers, unsolicited tender offers, privatisations, international joint ventures, special-committee representations and venture capital investments. In the finance area, he has represented issuers and underwriters in public offerings of equity and debt, commercial paper and euro medium-term note programmes, Rule 144A offerings, and the organisations and offerings of alternative investment fund products. After graduating *magna cum laude* from Harvard College, he was admitted to a dual-degree programme offered jointly by Harvard Law School and Harvard Business School and was awarded a J.D., *cum laude*, and an MBA.



### Richard A. Presutti

Schulte Roth & Zabel LLP  
919 Third Avenue  
New York, NY 10022  
USA

Tel: +1 212 756 2063  
Fax: +1 212 593 5955  
Email: [richard.presutti@srz.com](mailto:richard.presutti@srz.com)  
URL: [www.srz.com](http://www.srz.com)

**Richard A. Presutti** is a partner in the Business Transactions Group at Schulte Roth & Zabel LLP. He practises primarily in the areas of private equity, mergers and acquisitions, leveraged buyouts and alternative asset management transactional matters, and he also regularly represents a number of high-profile private equity firms in many transactions across a range of industries. In recognition of his transactional expertise and commitment to client service, as well as for advising on an award-winning transaction for a well-known private equity client, he was named "North America Lawyer of the Year" by Global M&A Network's Americas M&A Atlas Awards and is among Global M&A Network's elite group of the top 50 most influential North America M&A Lawyers. He received his B.S. from Bentley University and his J.D., *cum laude*, from Tulane University Law School.

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**Schulte Roth & Zabel LLP** ("SRZ") is a full-service law firm with offices in New York, Washington, D.C. and London. SRZ attorneys advise on some of the most sophisticated domestic and cross-border private equity transactions ranging from billion dollar-plus to small-cap deals serving clients that include many of the most active and influential private equity firms. The firm is actively involved in every aspect of the private equity investment process, from the formation of leveraged buyout, venture capital, real estate and other private equity and mezzanine funds, to the representation of these funds and other private equity investors in making investments, through realisation events including acquisitions, corporate financings and sales.

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59 Tanner Street, London SE1 3PL, United Kingdom  
Tel: +44 20 7367 0720 / Fax: +44 20 7407 5255  
Email: [sales@glgroup.co.uk](mailto:sales@glgroup.co.uk)

[www.iclg.co.uk](http://www.iclg.co.uk)